



INDIA STATE FISCAL MANAGEMENT REFORM ASSESSMENT

CHEMONICS INTERNATIONAL INC.

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FINAL ASSESSMENT

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Executive Summary

The objective of the State Fiscal Management Reform Assessment is to pull together the factual information needed to establish pragmatic and realistic suggestions for USAID to consider as a means to increase the capacity of selected State governments to improve fiscal management. Accordingly, a Team of four specialists traveled to India between October 4th and November 2nd, 2001 to assess the prospects for USAID involvement in State fiscal management reforms. The Team distilled the terms of reference into three fundamental questions:

1. What is the nature of the problem with State finances?
2. Is there a role for USAID in this area?
3. If so, where can USAID add value?

The Team concluded that there are a number of significant weaknesses with State finances. The States are borrowing funds at high rates of interest to finance relatively unproductive expenditures on wages, pensions, subsidies to public sector undertakings and interest on State debt. Deep cuts in discretionary expenditures, particularly for school and medical supplies, reduce the productivity of expenditures on education and healthcare in terms of increasing the rate of literacy and decreasing infant mortality. Finally, the share of GDP that is going to needed capital investments in physical and social infrastructure are declining as States borrow to cover revenue deficits. In short, the “crisis” of State finances diminishes the capacity of the States and the International donor community to address pressing socio-economic issues, such as high rates of infant and maternal mortality, illiteracy and poverty.

The Team concludes that there is a role for USAID involvement in State fiscal management reform. USAID may wish to consider giving priority to establishing a fiscal analysis unit; assisting development of high priority databases for fiscal analysis, such as strengthening Treasury operations and Human Resources database; and strengthening the capacity of States to produce key socio-economic indicators by district on a regular and timely basis.

These interventions would support good governance in significant ways. Establishing a fiscal analysis unit would help make the budget formulation process more predictable, open and enlightened. The failure of State governments to evaluate the near term fiscal implications of policy choices is clearly not enlightened policy making or in furtherance of the public good. In many States, actual expenditures bear little resemblance to planned expenditures as described in the budget. In order for civil society to participate, for example, meaningfully in public affairs, it is helpful if government processes are transparent. The State budget document is the public’s primary source of information on the activities of State government. Modernizing Treasury operations would strengthen budget execution and help ensure that there is an appropriate correspondence between actual and planned expenditures and, thereby, strengthen civil society by providing them with more accurate information on State activities. Finally, policy making would benefit from regular and timely availability of key socio-economic indicators by State districts.

The Report of the State Fiscal Management Reform Assessment Team

Purpose of the India State Fiscal Management Reform Assessment

The USAID/India Mission is presently in the process of formulating a new five-year development strategy for India. During the next six months the Mission will complete a variety of detailed sector assessments that will serve as the basis for developing specific sector activities that will be included in the new Strategy. The objective of the State Fiscal Management Reform Assessment is to pull together the factual information needed to establish pragmatic and realistic suggestions for USAID to consider as a means of increasing the capacity of selected State governments to improve fiscal management.

Organization of the Report

This report gives a basic, non-technical overview of the main findings of the Assessment Team. In addition, Annexes II through X deal more extensively with the major issues:

Annex II:	Overview of India's Fiscal Situation
Annex III:	Major Contributors to State Fiscal Deficits
Annex IV:	GOI and International Assistance to State Fiscal Management Reform
Annex V:	Decentralization
Annex VI:	Three Case Studies: Jharkhand, Karnataka and Uttar Pradesh
Annex VII:	Overview of Management Information Systems in Three States
Annex VIII:	An Overview of Treasury Systems
Annex IX:	The Fiscal Planning and Analysis Cell
Annex X:	Checklist for Sound Fiscal Management.

For the reader's convenience, we also furnish the following information:

Annex I:	Approach (Terms of Reference)
Annex XI:	List of Interviewees
Annex XII:	Reference Materials
Annex XIII:	List of NGOs in Jharkhand
Annex XIV:	Jharkhand's Organizational Setup
Annex XV:	The States' Fiscal Reforms Facility (2000-01 to 2004-5)
Annex XVI:	Personnel Qualifications.

Terms of Reference

The complete terms of reference (TOR) for the State Fiscal Management Reform Assessment are provided in Annex I. The Team distilled the TOR into three fundamental questions:

1. What is the nature of the problem with State finances?
2. Is there a role for USAID in this area?
3. If so, where can USAID add value?

In order to address these basic questions, a team of four specialists traveled to India between October 4th and November 2nd, 2001. The Team consisted of a macroeconomist with a focus on public finance (Dr. Roy Bahl); a local expert on Indian State finances (Dr. John Kurian); a public finance specialist (Dr. Mark Rider); and a public sector enterprise specialist (Mr. Michael Schaeffer). For the reader's convenience, the qualifications of each team member are provided in Annex XVI of this report.

The following is a brief description of the Team's approach to the State Fiscal Management Reform Assessment. The Team's time in the field can be broken down into two parts. The first part - week 1 - was spent in Delhi interviewing officials of the Government of India (GOI), representatives of bilateral and multilateral donors, specifically the Asian Development Bank (ADB), the United Kingdom's Department of International Development (DFID) and the World Bank (WB), and scholars affiliated with fiscal "think tanks."

The Team also had lengthy discussions with members of the USAID Mission in order to develop an assessment strategy that would be responsive to the needs of the Mission. During this phase of the Assessment, the team focused on three specific issues: soliciting a variety of views on the nature of the problem with State finances; developing a list of potential interventions in support of State fiscal management reform; and assessing the opportunity for USAID to collaborate with other donors on activities related to State fiscal management reform and restructuring.

During the second phase of the Assessment - weeks 2 through 4 - the team visited three States: Jharkhand, which is a newly formed State; Karnataka, which is a fast-reforming State; and Uttar Pradesh, which is a slow-reforming State. In each of the three States, the Team interviewed high-ranking representatives of the Department of Finance, Department of Planning and a variety of sector departments, such as health, power and rural and urban development. In addition to soliciting ideas from these officials on potential USAID interventions, the Team discussed their reaction to the list of interventions developed by the Team during week 1 in Delhi. Finally, the Team collected factual information on the fiscal condition of each State, discussed their priority needs and tried to assess each State's receptivity to USAID engagement in this area. A complete list of the people interviewed during this four-week period is provided in Annex XI. Annex XII provides a list of the reference materials used in this Assessment.

What is the Nature of the Problem with State Finances in India?

As shown in Table 1, throughout the past decade State revenues as a share of GDP (column 2) have been declining more rapidly than the share of State expenditures (column 1). The obvious consequence of this trend is a widening gap between expenditures and revenues or,

in other words, a growing State Revenue Deficit (column 3) as a share of GDP. The States are financing their Revenue Deficits (RD) through borrowings, which results in rising State debt (column 4) as a share of GDP.

Table 1: A Few Key Indicators of State Finances

Year	State Expenditure (% of GDP)	State Revenue (% of GDP)	Revenue Deficit (% of GDP)	State Debt (% of GDP)
1990-91	13.2	11.6	1.6	19.47
1991-92	12.9	12.3	0.6	19.37
1992-93	12.9	12.2	0.7	19.04
1993-94	12.7	12.3	0.4	18.63
1994-95	12.7	12.1	0.6	18.27
1995-96	12.3	11.6	0.7	18.72
1996-97	12.4	11.2	1.2	17.88
1997-98	12.4	11.2	1.2	18.53
1998-99	12.5	10.0	2.5	19.36
1999-00	12.5	9.6	2.9	21.57
2000-01	12.5	10.0	2.5	22.77

Source: Reserve Bank of India (RBI)

From Table 1, it would appear that the growth in State RD is a direct result of the inability of the States to mobilize sufficient revenues. Although technically correct, this conclusion fails to account for a number of other weaknesses in State finances.

More specifically, during this period interest, salary and pensions have registered unprecedented growth:

- pension expenditures of the States have doubled in the past two years;
- the wagebill has more than doubled in the past three years; and
- the interest burden has nearly doubled over the past ten years.

As shown in Table 2, State expenditures on interest and pensions as a share of State revenue have nearly doubled during the last decade. On average, expenditures on salary, pension and interest account for approximately 60 percent of State revenues. Expenditures on salary, pension and interest are committed expenditures; thus the States currently have limited flexibility to adjust expenditures in response to changing priorities, economic downturns or emergencies.

Table 2: A Few Key Indicators of State Finances

Year	Interest + Pension	Tariff recovery
1990-91	17.47	-
1991-92	17.59	-
1992-93	17.61	82.2
1993-94	18.52	78.3
1994-95	20.57	78.3
1995-96	21.50	77.4
1996-97	23.07	76.7
1997-98	23.77	75.2
1998-99	28.30	70.7
1999-00	36.63	70.2
2000-01	36.61	69.8

The growth in committed expenditures - salary, pensions and interest - in the face of an overall decline in total expenditure as a share of GDP suggests that States are cutting discretionary expenditures in order to contain deficit spending. Indeed, over 98 percent of expenditure on education in Karnataka is for teacher salaries. Consequently, very little money is being spent on books, school supplies and operation and maintenance of school buildings. Likewise, over 95 percent of the expenditure on health in Karnataka is for salaries. Again, this implies very little money is being spent on diagnostic equipment, vaccines and medicines. In short, paying for salaries while teachers and doctors lack adequate supplies suggests that expenditures on education and health may not be very productive in terms of reducing illiteracy, infant mortality and maternal mortality, etc.

Table 2 also shows that the rate of cost recovery by public sector undertakings (column 2) has steadily declined during this period. The States have to make up the difference through subsidies paid out of current State revenues and, consequently, there is less money available for other important activities of State government. In fact, budgetary subsidies of the State governments currently account for 8.8 percent of GDP and about 96 percent of revenue receipts of the States.

A possible rationale for such subsidies is to help the poor who otherwise may be excluded from these services if they have to pay the full cost of provision. If the aim is to help the poor, however, these subsidies are poorly targeted. Agriculture and irrigation sectors account for the largest share of State subsidies, followed by elementary education, energy, secondary education and medical and public health. Subsidies to agriculture, irrigation and energy, in particular, benefit the rich as well as the poor. In fact, evidence shows that per capita subsidies generally show a regressive pattern: States with higher per capita income pay higher subsidies per capita.

On the revenue side, as shown in Table 3, States' own tax-revenues as a share of GDP (column 1) have been rather stable during this period. On the other hand, non-tax revenues of the States as a share of GDP (column 4) have been steadily declining. This is further evidence that low cost recovery by public sector undertakings is a drain on State finances. The share of Central

tax revenues (column 2) devolving to the States during the second half of the nineties fell significantly short of the projections of the Tenth Finance Commission reflecting the decline in the tax-to-GDP ratio of the Center since 1997-98.

Table 3: Components of State Revenues as a Percentage of GDP

Year	Tax Revenues			Non-Tax Revenues			Total Revenues
	Own Tax Revenue	Share of Central Taxes	Total Tax Revenue	Own Non-Tax Revenue	Central Grants	Total Non-Tax Revenue	
1990-91	5.3	2.5	7.8	1.6	2.2	3.8	11.6
1991-92	5.5	2.6	8.1	1.9	2.3	4.2	12.3
1992-93	5.3	2.8	8.1	1.7	2.4	4.1	12.2
1993-94	5.4	2.6	8.0	1.8	2.5	4.3	12.3
1994-95	5.5	2.5	8.0	2.1	2.0	4.1	12.1
1995-96	5.4	2.5	7.9	1.9	1.8	3.7	11.6
1996-97	5.2	2.6	7.8	1.7	1.7	3.4	11.2
1997-98	5.4	2.7	8.0	1.6	16.0	3.2	11.2
1998-99	5.3	2.3	7.6	1.4	1.7	3.1	10.7

Source: Reserve Bank of India (RBI)

In short, the States responded to the emerging situation by borrowing to fill the revenue gap rather than making greater efforts to contain expenditure in a more rational way without jeopardizing the quality of key services, like health and education, or to augment revenues. As a consequence, the State Debt-to-GDP ratio, which was less than 18 percent as recently as 1996-97, shot up to nearly 23 percent by 2000-01 (see Table 1).

In addition to the growing debt burden of the States, the composition of State borrowings is a matter of serious concern. Rather than borrowing to make needed capital investments in roads, water supply and treatment, irrigation, hospitals and schools, the States are using an increasing share of their total borrowings to cover revenue expenditure deficits. In other words, the States are borrowing to pay for wages and salaries, pensions, subsidies on public sector undertakings and interest on State debt. Although it is important for States to meet their obligations in this regard, these expenditures do not add to the productive capacity of the economy or increase the ability of the States to repay these loans.

Table 4: Gross Fiscal Deficit and Revenue Deficit as a Percentage of GDP

Year	Gross Fiscal Deficit			Revenue Deficit			Share of RD in GFD		
	Center	States	Combined	Center	State	Combined	Center	State	Combined
1990-91	7.8	2.7	10.6	3.3	0.9	4.2	42.3	33.3	39.6
1991-92	5.6	2.9	8.4	2.5	0.9	3.4	44.6	31.0	40.5
1992-93	5.4	2.8	8.2	2.5	0.7	3.2	46.3	25.0	39.0
1993-94	7.0	2.4	9.4	3.8	0.4	4.2	54.3	16.7	44.7
1994-95	5.7	2.7	8.4	3.1	0.6	3.7	54.4	22.2	44.0
1995-96	5.1	2.7	7.8	2.5	0.7	3.2	49.0	25.9	41.0
1996-97	4.9	2.7	7.6	2.4	1.2	3.6	49.0	44.4	47.4
1997-98	5.9	2.9	8.8	3.1	1.1	4.2	52.5	37.9	47.7
1998-99	6.4	4.2	10.6	3.8	2.5	6.3	59.4	59.5	59.4
1999-2000	5.6	4.6	10.2	3.8	2.9	6.7	67.9	63.0	65.7

Source: Based on RBI statistics

The aggregate Gross Fiscal Deficit (GFD) of the States is a measure of total State borrowings in a given year. These borrowings are used to make capital investments as well as cover State Revenue Deficits. As shown in column 2 of Table 4, the aggregate GFD of the States has been growing rapidly as a share of GDP since 1996-97.

Two trends in Table 1 are worrisome. First, as described above, the rapid growth in State Revenue Deficits since 1996-97 point to a number of weaknesses in State finances. In particular, the reduction of discretionary expenditures and the resulting deterioration in the quality of public expenditures. Second, as shown in column 8 of Table 4, State Revenue Deficits as a share of aggregate GFD of the States has increased from nearly 33.3 percent in 1990-91 to 63 percent in 1999-00. In other words, the growing need for States to borrow in order to cover Revenue Deficits diminishes their ability to borrow for needed capital investments in infrastructure in support of continued economic growth. Taken together the reduction in discretionary spending and the decrease in capital investments as a share of GDP point to a deteriorating quality of public services, now and in the future.

These fiscal trends also negatively impact on women. For example, the relatively high school drop out rates in some States, like Jharkhand, is attributed, at least in part, to the lack of toilets and potable water at many public schools. A disproportionate number of such dropouts are young girls. Thus, the lack of money for operation and maintenance of school buildings due to the poor fiscal condition of the States means that efforts to improve female literacy rates may suffer. Similarly, the lack of medical supplies in public clinics and hospitals due to State fiscal stress negatively impacts State efforts to reduce infant and maternal mortality. In short, the fiscal health of the States has important implications for efforts to improve gender equity in India.

To the casual observer, the decline in the quality of public expenditure is perhaps most evident in the poor quality of the roads and electric power in India. There also is evidence that those who can afford it – the growing middle class in India – are increasingly using private healthcare and schools in response to the deterioration in the quality of public sector offerings. Meanwhile, businesses are leaving the power grid and using private generators to ensure a steady and reliable supply of electric power. These understandable responses to the declining quality of public expenditure negatively impact on the poorest members of society because they cannot afford private alternatives.

It is important to note that the current fiscal “crisis” facing the States is largely the result of policy choices made by the States rather than events completely outside their control. For example, the States adopted the generous salary increases recommended by the Fifth Pay Commission. This resulted in the rapid growth of wage and pension liabilities, which have exacerbated the fiscal problems now facing the States. But, the States did not have to adopt these recommendations; it was elective on their part. Likewise, the declining rate of cost recovery by public sector undertakings reflects State policy choices. States took decisions that increased the cost of service delivery by unnecessarily increasing staffing levels, while tariffs and fees were not increased in tandem to reflect the higher cost of providing services. As a result, these operating losses have to be covered through increased budgetary subsidies paid out of State revenues that undoubtedly could be used more productively in other sectors. Apparently, policy

decisions have been made for the sake of immediate political gain without recognizing the medium-term fiscal implications of these choices.

Is a crisis due to the problems with State finances imminent? The combined GFD of the States and Center is approximately 10 percent (column 3 of Table 4). This is approximately the same level that led to the 1992 crisis. Now, however, a far greater share of total debt is borne by the States. Since the debt of the States is largely financed through internal borrowings, there is less external debt exposure today than in the early nineties. Consequently, macroeconomic instability – an accelerating rate of inflation, rising interest rates, economic recession and growing unemployment - does not appear to be imminent.

As long as the Center is willing and able to support State borrowings without incurring excessive external debt, the States should be able to muddle through. But, muddling through almost surely means a continuing decline in the quality of roads, water supply, education and healthcare. The lack of investment in physical infrastructure also puts at risk robust economic growth, which is probably the most effective poverty reduction program. Unless these problems are adequately addressed, they will result in growing regional disparities and, perhaps, over the long haul growing political instability. Though we do not want to be alarmist, a few knowledgeable and mature observers did express concerns that these negative trends in State finances, if allowed to continue, could threaten the future of the Federation itself.

Is There a Role for USAID in Supporting State Fiscal Management Reform?

There are a number of significant weaknesses in State finances. The States are borrowing funds at high rates of interest to finance relatively unproductive expenditures on interest, salaries, pensions and subsidies to public sector undertakings. Meanwhile, the States have cut essential discretionary expenditures on medical and school supplies. These cuts reduce the productivity of expenditures on education and healthcare in terms of improving important social outcomes, such as the rate of literacy and infant and maternal mortality. Finally, as States borrow to cover RD, the share of GDP that is going to needed capital investments in social and physical infrastructure, such as roads, schools, hospitals and water supply and treatment, is declining. In short, the “crisis” of State finances diminishes the capacity of the States and the international donor community to address pressing socio-economic concerns, such as high rates of infant and maternal mortality, illiteracy and poverty.

The Team concludes that there is indeed a role for USAID to get involved in State fiscal management reform for the following reasons. First, as described above, India’s ability to address pressing socio-economic concerns critically depend on addressing the fiscal condition of the States. In fact, the current fiscal condition of the States is negatively impacting efforts by the GOI, the States and the international donor community to reduce poverty, illiteracy, and infant and maternal mortality. Second, there are many States facing difficult fiscal problems that are not receiving any outside assistance and even among those that are receiving outside assistance there are, by their own admission, significant gaps in the assistance. Third, there is broad support for USAID involvement in State fiscal management reform among the States, the GOI and the

multilateral donors. Fourth, USAID has a long and successful track record sponsoring the proposed interventions described below.

The officials in the States that we visited clearly recognize the need for fiscal restructuring and acknowledge that fiscal management reforms are required. In reaching the conclusion that there is a role for USAID, the Team placed a heavy weight on our perception of the State's receptivity to fiscal management reform because counterpart buy-in is crucial to the success of any proposed activities in this area. Table 5 below summarizes each State's receptivity to proposed interventions. For example, the Head of the Department of Revenue in Uttar Pradesh was quite clear that support for VAT implementation was not needed there, while the Head of Treasury operations was quite enthusiastic. The State attitude toward each proposed intervention is reflected in Table 5. The table also indicates potential all-India programs that would support specific State interventions and allow USAID to realize cost savings through economies of scale. The proposed interventions are described in greater detail below.

Table 5: Summary of Potential USAID Interventions by State

All States	Uttar Pradesh	Jharkhand	Karnataka
National Forum on Strengthening MIS Capabilities.	1. HR Database 2. Strengthen Treasury Operations	1. HR Database 2. Strengthen Treasury Operations	1. HR Database 2. TO modernization in progress
National Training Program in State Fiscal Management	Capacity Building for Performance Based Budgeting	Capacity Building for Performance Based Budgeting	Capacity Building for Performance Based Budgeting
National Forum on Fiscal Analysis	Establish Fiscal Analysis Unit	Establish Fiscal Analysis Unit	Establish Fiscal Analysis Unit
National Forum on VAT Implementation	No help needed in tax administration.	Comprehensive Tax Administration System	VAT Implementation: 1. Construct I-O table to computer revenue-neutral-rate 2. Computerization of VAT administration 3. Audit selection software
Building Analytical Capacity	Build analytical capacity to prepare, evaluate and manage tender process.	Build analytical capacity to prepare, evaluate and manage tender process.	1. Est. Analytic Cell in Directorate of Economic Statistics. 2. Office of Finance Controller (capacity building req.) 3. Est. Project Appraisal Unit 4. Est. PSE Analysis Unit
Institutionalize Medium-Term Fiscal Framework	Institutionalize Medium-Term Fiscal Framework	Does not have a MTFF	Analytical research cell to develop MTFP for each department.

In our discussions with representatives of the ADB and WB, they made it clear that they would welcome USAID involvement in the States in which they are working. In fact, they provided the Team with a list of interventions that would complement and support their efforts in State fiscal restructuring and management reforms. The willingness of these donors to work with USAID as partners is crucial, if USAID decides to “piggy-back” interventions on those of a larger donor.

The GOI also places a high priority on restructuring State finances. This is evidenced by the special facility that the Center developed to support State fiscal reforms. For the reader's convenience, a copy of the terms of this facility is provided in Annex XV and key elements are described in Annex IV. Furthermore, the MoF's Department of Economic Affairs (DEA) expressed a lot of interest in this assessment. In addition to the customary pre-briefing, they requested and received a de-briefing at the conclusion of the assessment. During the de-briefing, they expressed general agreement with our conclusions. They also seemed persuaded that the proposed interventions that the Team described to them are reasonable in light of the nature of problems with State finances and USAID's resources. DEA gave USAID a "green light" to continue to pursue involvement in State fiscal management reform. DEA also made it clear that they would welcome and strongly encourage USAID involvement in one or more of the Northeastern States and/or newly formed States.

Finally, the Team provided a pre-brief and de-brief to USAID/Washington. In particular, John Crifield (CTO, SEGIR/Macro-Economic Policy) and Mark Gellerson (Principal Economist, USAID/Asia Near East Bureau) attended both briefings. They expressed a great deal of interest in the assessment and asked a lot of questions. The Team left the de-briefing with the impression that they would like to see USAID/India providing support to State fiscal management reforms.

Below is a list of these gaps and complementary activities in State Fiscal Management Reform for USAID consideration. The State Fiscal Assessment Team developed the following list based on discussions with representatives of the GOI, the international donor community and the States. The following list is not ranked according to priority. We address the issue of priority below.

1. *Civil Service Reform.* There is a need for a Human Resources database. Although the States we visited claim to have a complete list of current employees and their pay grade, this should not be taken for granted in every State. Apparently, some States do not have such information. Such a database would be an obvious first step in helping a State begin to understand their wage bill and the fiscal implications of various employment and compensation policies. The WB thought that this would be especially important for Uttar Pradesh. There already may be a request for this to USAID.
2. *Civil Service Pension Reform.* The States do not understand the fiscal costs of pensions and lack the necessary data to produce good forecasts of future pension liabilities. The States cannot evaluate the implications of reform options, or even of fiscal decisions. USAID could help one or more States compile the necessary data on current employees and pensioners and provide technical assistance in the development of a model to simulate pension liabilities under current law and proposed law.
3. *Debt Management.* USAID could provide technical assistance to help State treasuries estimate the fiscal impact of different sources of finance.

4. *Implementation of a Medium Term Fiscal Framework.* As previously discussed, each State receiving loan funds from the ADB or WB must develop a Medium Term Fiscal Framework (MTFF). Furthermore, the GOI requires every State to develop a MTFF as part of the States' Fiscal Reforms Facility (Annex XV). These frameworks are very detailed and ambitious, requiring that States achieve pre-defined targets for reducing deficits as well as implementing specified institutional reforms. Although ADB and WB may provide targeted technical assistance in support of implementing MTFF, they do not provide on-the-ground capacity building. USAID could assist with implementation of a State's MTFF through capacity building in a variety of areas, such as general fiscal training, budget management and policy analysis, etc.
5. *VAT Implementation.* The States have agreed among themselves to replace the existing sales tax regime, which currently is their primary source of own-revenue, with a sub-national VAT. VAT implementation is scheduled to begin on April 1, 2002. Table III.C (see Annex III) describes a variety of activities that must be completed in order for a State to successfully implement the VAT, including drafting enabling legislation, designing tax forms, training administrative personnel, public awareness campaign, register taxpayers, etc. USAID could support VAT implementation by assisting with these activities.
6. *Civil Society.* USAID could create demand for State fiscal management reforms by strengthening civil society. There are many dimensions to this, such as developing local think tanks; working with "watchdog" groups; media development; surveys of service delivery quality; etc.
7. *Treasury Operations.* Although some progress has been made in computerizing Treasury Operations, it is primarily a data storage and retrieval system. Further computerization would be very valuable. There are several ways to address this problem. For example, all of the treasuries in a given State have not been computerized in Uttar Pradesh and Jharkhand. USAID could provide technical assistance and capacity building in support of completing computerization of treasury operations. Uttar Pradesh currently is moving from the existing FoxPro-based system to an Oracle-based one. USAID could help with completing this transition by, for example, training staff to use the new Oracle-based system. Generally, the States do not use the treasury data to their fullest advantage to manage cash, monitor expenditures, prevent fraud and abuse, etc. USAID could help selected States, particularly Uttar Pradesh and Jharkhand, to develop the necessary software to generate management reports and assist with training personnel to produce, interpret, and use these reports for making better decisions. Annex IX gives a more complete description of what is required for modern State Treasury operations.
8. *Establish Fiscal Analysis Unit.* As previously discussed, the States that we visited do not have a specialized staff dedicated to conducting fiscal analysis on a regular basis. The lack for forward planning may have contributed to the adoption of policies, such as the recommendations of the Fifth Pay Commission, that have led to the present "crisis" of State finances. USAID could assist with establishing a fiscal analysis unit

in the Department of Finance in a few selected States. Annex VII gives a more complete description of the role and duties of a fiscal analysis unit.

9. *Establish Project Appraisal Unit.* The sector departments (roads, water, health, education, etc.) are responsible for developing projects, including the supporting documentation, cost-benefit analysis and time to completion. The Planning Department is responsible for evaluating project proposals, prioritizing them and submitting them for consideration for inclusion in the budget by the Department of Finance. The Planning Departments lack the capacity to evaluate the realism of the supporting documentation for projects. More specifically, they do not have the capacity to evaluate the cost-benefit analyses, cost estimates and time required to complete a project. USAID could provide technical assistance and capacity building in support of the establishment of a Project Appraisal Unit in the Department of Planning in a few selected States.
10. *Training in State Finances.* USAID could support needed training in the following areas: decentralization, general fiscal training of State officials, budget management and policy analysis.
11. *Decentralization.* The States that we visited, and in particular Jharkhand and Karnataka, are committed to decentralizing important government activities to the third-tier of government (i.e., rural Panchayats and Urban Local Bodies). For example, it is anticipated that the third-tier of government will assume increasing responsibility for water supply and treatment and primary education. As such, these governments will need to develop an autonomous capacity to develop budgets, monitor expenditures, conduct project development studies and raise own-source revenues. Currently, this capacity is completely lacking in the rural Panchayats and many of the Urban Local Bodies. Therefore, USAID could support decentralization by supporting capacity building and training in these areas.
12. *Strengthening of Management Information Systems.* In general, the States appear to lack management information systems. In Jharkhand, for example, the Department of Urban and Rural Development needs an updated survey of major infrastructure on village and rural Urban Local Bodies. The lack of such data makes it very difficult for the State to assess needs and prioritize projects. The Department of Education does not have a way to collect timely information on the number of students, by age and grade level with associated information on their scholastic achievement, such as level of literacy. Again, this makes it difficult to assess needs and performance and to allocate funds in order to improve educational outcomes and increase accountability. Another glaring problem is the lack of computerization of tax administration. Currently, many States are using manual procedures. Modern tax administration is very dependent on computerization. Computerization of Treasury operations and the development of human and pension databases also fall into this category. Finally, where electronic databases exist, they are not properly utilized as a management tool. Annex VIII describes the status of management information systems (MIS) in the three States. USAID could support the development of one or more MIS and provide

training in the use of such data as a tool for making informed decisions. Human resources and Treasury operations would appear to be high priority areas.

13. *Improve Socio-Economic Data.* Much of the basic data used by the States to evaluate socio-economic conditions and progress over the years are taken from the population census. Much critical data is not available annually or during the decennium. Even census reports are published after substantial time lags. Consequently, disaggregated district level data pertaining to 1991 have become available only after 1996. As a result, decisions based on such data tend to be flawed and ineffective. Vital indicators for districts based on census data are also not free from errors. Deficiencies occur in census data because of discrepancies in reporting ages as well as missing events at the time of the field interviews. In the period between two censuses, there is no mechanism to obtain reliable indicators on human development. A reliable mechanism must be devised to compile crucial information between censuses so that the success of public policies in education and health can be evaluated. There are several crucial areas for which no information is at present being collected. At the present time, there is no system in the country to compute the maternal mortality rate at regular intervals even for States, let alone districts. There is no established and statistically valid procedure to estimate the literate population between censuses. Official machinery at the district level does not collect several kinds of key data that is critical for measuring human development. Data on children's height and weight, the quality of education and health services or the potability of drinking water are not collected frequently. USAID could provide technical assistance and capacity building in the development of regular human development surveys. Also, USAID could provide training to develop the institutional capacity to analyze such data and train policy-makers in the use of such data for fiscal decision-making.

Where Can USAID Add Value in State Fiscal Management Reform?

As previously noted, the current "crisis" of State finances is largely the result of policy choices made by the States. Examples of which include adopting the pay recommendations of the Fifth Pay Commission and allowing the rate of cost recovery among public sector undertakings to decline. In the opinion of the Assessment Team, the most glaring deficiency of State fiscal management is the lack of an institutional structure to support forward looking fiscal decision-making that is well grounded in careful analysis and fact.

Since the early nineties the GOI has pursued economic liberalization that entails the States assuming greater fiscal autonomy. But, the States were ill-prepared for their new role. The most obvious need, in our opinion, is for the States to develop institutional structures to support forward-looking fiscal analysis. Such analysis could stop or, at the very least, significantly improve policies that are not consistent with the future fiscal health of the State.

Accordingly, USAID should consider helping a few selected States establish a fiscal analysis unit and further develop high priority databases for fiscal analysis, such as strengthening State treasury operations and Human Resource (HR) databases. Resources permitting, USAID

also could strengthen the capacity of the States to produce key socio-economic indicators on a regular and timely basis and train policymakers in the value and use of such data in the budget making process. The ranking of the proposed interventions and the decision criteria are summarized in Table 6 below.

There are a number of advantages to the proposed interventions described above. First, they are discrete. In other words, they could work in tandem with the efforts of a multilateral donor engaged in significant lending activity in support of fiscal restructuring in a State. On the other hand, the proposed interventions do not depend on the presence of a large multilateral institution for their success. Second, these interventions represent critical gaps that other international donors currently are not filling and they would welcome USAID assistance in filling them. Third, the U.S. has tremendous strength in fiscal analysis; computerization of treasury operations; and developing socio-economic data in developing and transitional economies. More specifically, there are many U.S. based universities and consulting firms that have tremendous experience in these areas. Thus, the proposed interventions would certainly fall within USAID's comparative advantage. Finally, a fiscal analysis unit and the associated database development could be supportive of USAID's sector activities in selected States, particularly in health, power and irrigation.

Ideally, one would like to improve budget formulation to take into account the fiscal implications of policy proposals by establishing a fiscal analysis unit; improve budget execution by strengthening Treasury operations; and create the capacity to collect key socio-economic data on a regular and timely basis in a few selected States. These are complementary activities that at get at the root of improved State fiscal management.

If, however, funding levels do not permit USAID to undertake all three activities in one or more States, then the Team would give priority to establishing a fiscal analysis unit as a standalone activity. A fiscal analysis unit would stimulate demand within government to pursue these other important reforms. Whereas, beginning lower down in the hierarchy of control, by for example strengthening Treasury operations or creating an HR database, may not have the same ripple effect.

If resources are judged insufficient to support establishing a fiscal analysis unit as a standalone activity in one or more States, then USAID should consider one or more of the others as stand-alone activities. For example, USAID could strengthen Treasury operations in a few selected States. Time and again, the Team was told that the allocation of expenditures described in State budget documents do not accurately reflect the final disposition of funds. In other words, the States need to improve budget execution. Strengthening Treasury operations in the most obvious way to guarantee that monies are spent as intended in the budget. There are other advantages of this activity as well. First, improving budget execution, should contribute to the improvement of the quality of public expenditure. Another advantage is that it would allow USAID to achieve cost savings through economies of scale. In other words, strengthening Treasury operations in one or more States could be replicated in others at very little added cost by convening regular National Forums among State Treasury officials to discuss experiences and potential solutions. The main disadvantage of this intervention as a standalone activity is that it does not address weaknesses in the budget making process, in particular the failure to take proper account of the fiscal consequences of policy decisions, which is the source of the problem.

Table 6: Decision Matrix

Ranking of the Proposed Intervention	Cost per State/year (millions \$'s)	Are there economies of scale?	Is the State receptive to the proposed activity?			Is the proposed activity a significant gap in the State?			Is the proposed activity a comparative advantage of USAID?	Expected timeline of impact
			Jharkhand	Karnataka	UP	Jharkhand	Karnataka	UP		
1. Est. fiscal analysis unit	1.5 - 2.0	High	High	High	High	High	High	High	High	1 yr
2. Strengthen treasury operations	0.2 - 0.3	High	High	Low	High	High	Low	High	High	1 yr
3. Stengthen human resource database	0.10 - 0.15	Medium	High	High	High	High	High	High	High	1 yr
4. Improve socio-economic data	0.15 - 0.25	Medium	High	High	High	High	High	High	High	1 yr
5. Implementation of MTFF	0.3 - 0.5	Medium	Low	High	High	Low	High	High	Medium	2 yr
6. Establish project appraisal unit	1.5 - 2.0	Medium	High	High	Medium	Medium	Medium	Medium	Medium	1 yr
7. Strengthen Civil Society	0.5 - 1.0	Low	High	Low	Medium	High	Low	Medium	High	2 yr
8. Decentralization	4.0 - 5.0	Low	High	High	Medium	Meidum	Medium	Medium	High	3 yr
9. Strengthen tax admininstration	1.5 - 2.0	Medium	High	Medium	Low	High	Low	Low	Medium	2 yr
10. Training in fiscal analysis	0.5 -1.0	Low	High	Low	Low	Medium	Medium	Low	High	2 yr
11. VAT Implementation	3.0 - 4.0	Medium	Medium	Low	Low	Medium	Low	High	Low	2 yr

Note: Between USAID, ADB, and WB, these interventions have been successful in many transitional and developing countries.

If resources are judged insufficient to strengthen Treasury operations, then USAID may want to consider assisting one or more States in strengthening their capacity to produce key socio-economic indicators on a regular and timely basis. In addition, USAID could provide support in strengthening the capacity of government officials in analyzing these data and using them in the budget making process.

The major advantages of this intervention are threefold. It could be replicated in other States at relatively little additional cost to USAID. It would allow States better to identify priority needs and thus support improved budget making. Finally, it may even assist USAID in monitoring their programs. As a standalone activity, however, this intervention does not create the necessary institutional structures for improved fiscal decision-making or budget execution.

The Team recommends against USAID involvement in certain activities. Specifically, the Team recommends against USAID involvement in capacity building in support of decentralization (number 11 above) because it would require tremendous amounts of resources in order to have a measurable impact. Furthermore, the success of decentralizing to the third-tier critically depends on rationalizing State finances. Although a Project Appraisal Units (number 9 above) are needed, in our opinion it is a lower priority item. Finally, we also recommend against USAID getting involved in VAT implementation at this time. The resource requirements are significant and there is simply too much policy uncertainty at this time. Indeed, there are serious reservations among knowledgeable people about the timely implementation of VAT.

USAID also may be considering an indirect or sectoral approach to State Fiscal Management Reform. In other words, USAID could help “fix” the power and health sectors and thereby contribute to State fiscal restructuring. While there are certainly sector problems that need to be addressed as part of a program of fiscal restructuring, the concern is that resources freed-up through a successful intervention in the power sector, for example, may be wasted through tax concessions or public sector job creation schemes. As the States pursue sector reforms, they need to develop the capacity and habit of establishing budget priorities that are based on careful analysis. That would be one of the primary goals of establishing a fiscal analysis unit.

In the foregoing analysis, the Team has tried to provide a concise statement of the nature of the problem with State finances; describe a menu of possible interventions for USAID consideration; and share our thinking about the priority of these interventions. In order to develop a strategy, USAID expressed a desire to know about other international donor activity; the prospects for USAID collaboration with them; and whether the three visited States are representative of their type. We address these important issues in the following two sections.

What Are Others Doing in State Fiscal Management Reform?

The Government of India (GOI), Asia Development Bank (ADB), United Kingdom’s Department for International Development (DFID) and World Bank (WB) have programs in

place to support State fiscal management reforms. We briefly describe the activities of the GOI and international donors below and provide greater detail in Annex IV.

The GOI has created an incentive fund to encourage fiscal correction in the State sector and fiscal management reforms. Each State is required to negotiate a Memorandum of Understanding (MOU) with the Center. According to the terms of this facility, each State is expected to take effective steps for revenue augmentation and expenditure compression over the five-year period of this facility, 2000-01 to 2004-05, to broadly achieve the following objectives: Gross Fiscal Deficit of the States as an aggregate to fall to 2.5 percent of Gross State Domestic Product (GSDP) and Revenue deficit of all States, in an aggregate, to fall to zero.

Given the broad contours of the fiscal objectives sketched above, the State Governments should draw up a Medium Term Fiscal Restructuring Policy (MTFRP). The GOI has a list of specific recommendations that should be part of a State's MTFRP including fiscal objectives and reforms, power sector reforms, public sector restructuring and budgetary reforms. The terms of this facility are provided in Annex XV.

The ADB and WB are providing structural adjustment loans to selected States in support of State efforts at fiscal restructuring and fiscal management reforms. The loans are disbursed in tranches based on achievement of agreed upon goals or milestones. These milestones are formalized in detailed plans referred to as Medium Term Fiscal Restructuring Plans and are similar in coverage and purpose to the MTFRP required by the GOI.

DFID has concentrated its fiscal policy work in Orissa. In Orissa, DFID has developed a civil service employee database. This database takes into consideration employee numbers, age, date of service and the expected date of retirement. This database should enable the State government more clearly to determine its human resource needs and to quantify its future pension liabilities. DFID also engages in providing technical assistance on public expenditure management, manpower analysis, sales/VAT (tax administration) and public enterprise reform.

Table 7 provides a brief summary of International donor activity in State Fiscal Management Reform. ADB and WB welcome USAID's involvement in support of their activities in the States listed below. DFID did not see opportunities for collaboration with USAID, however no reason was cited.

One of the advantages of the proposed interventions described above is that they are discrete. Therefore, they could work in tandem with the efforts of a multilateral donor engaged in a significant lending program in support of State fiscal restructuring. On the other hand, these interventions do not depend for their success on the presence of a large multilateral institution. Furthermore, a fiscal analysis unit and the associated database development could be supportive of USAID's sector activities in selected States, particularly in health, power and irrigation. Finally, the list of proposed interventions provided above are gaps that other donors are not filling, but would welcome.

Table 7: Summary of Other International Donor Activity

Donor	State	Status
Asian Development Bank	Gujarat	Completed
	Kerala	Underway
	Madhya Pradesh	Underway
	Karnataka and Uttar Pradesh	Under consideration
DFID	Orissa (TA for fiscal management reform)	Underway
World Bank	Karnataka	Underway
	Uttar Pradesh	Underway
	Rajasthan	Under consideration

Are Jharkhand, Karnataka and Uttar Pradesh Representative?

As previously noted, the Team visited the following three States: Jharkhand, which is a newly formed State; Karnataka, which is a fast-reforming State; and Uttar Pradesh, which is a slow-reforming State. The choice of States was intended to reflect the three types: newly formed, fast- and slow-reforming. In order to develop a State strategy, it is helpful to know whether these States are representative of these types.

To address this issue, the Team categorized the twenty-five States into the three categories, according to widely held perceptions among Indian observers of State fiscal condition. Table 8 shows how the twenty-five States can be categorized into these three categories along with associated indicators of fiscal distress and socio-economic development.

A good indicator of the degree of fiscal distress that a State may be experiencing is the percentage of 364 days that the State treasury is in overdraft. Comparing slow-reform and fast-reform States, it is apparent in Table 8 that the slow-reform States have a greater percentage of days in overdraft. For example, the third most distressed “fast-reforming State,” at least according to this index, is Punjab (28.85). Among slow-reforming States, only Bihar, Jammu and Kashmir and Madhya Pradesh out perform Punjab. Furthermore, the ratio of revenue-deficit-to-gross-fiscal-deficit is an indicator of the degree to which States are diverting borrowings to cover recurrent expenditures instead of investing in infrastructure investments. Again, as evident in Table 8, the slow-reforming States generally have higher ratios than the fast-reforming States. The third highest ratio among the fast-reforming States is Haryana (68.75), which is lower than all but four of the slow-reforming States. In other words, slow-reforming States generally are using a greater share of borrowings to cover revenue deficits than fast-reforming States.

In addition, the percentage of total State revenue committed to interest, salaries and pensions indicates the quality of revenue expenditure. In many sectors, particularly health, expenditure on wages may not be very productive if it is not matched with significant expenditure on equipment and supplies (diagnostic equipment, vaccines, etc.). Although the data on the share of total State revenue committed to wages, pensions and interest is not complete, the information provided in Table 8 is suggestive. It appears that slow-reform States tend to spend a greater share of total State revenue on committed expenditures than fast-reform States.

Table 8: State-wise Indicators of Fiscal Distress and Socio-Economic Development

States	Indicators of Fiscal Distress			Indicators of Socio-Economic Development			
	Percentage of Days Treasury in Overdraft	Ratio of FD-to-GFD	Percentage of Revenue Committed	Infant Mortality 1997	Maternal Mortality 1992	Female Literacy 1991	Per Capita NSDP 1995-96
<i>Slow-Reform States</i>							
Assam	77.75	-26.67	n.a.	76	544	43.0	6,288
Bihar	22.25	56.77	n.a.	71	470	22.9	3,524
Jammu & Kashmir	0.00	37.96	n.a.	n.a.	n.a.	n.a.	n.a.
Madhya Pradesh	12.91	69.59	n.a.	94	711	28.8	6,518
Orissa	53.30	66.21	97.43	96	738	34.7	6,192
Rajasthan	35.16	58.17	94.77	85	550	20.4	6,959
Uttar Pradesh	57.42	74.76	n.a.	85	624	25.3	5,874
West Bengal	36.81	68.31	152.71	55	389	46.6	8,409
<i>Fast-Reform States</i>							
Andhra Pradesh	40.38	47.04	69.16	63	436	32.7	8,938
Goa	2.75	52.31	n.a.	n.a.	n.a.	n.a.	n.a.
Gujarat	9.34	50.96	n.a.	62	389	48.6	11,977
Haryana	25.55	68.75	n.a.	68	436	40.5	13,518
Karnataka	0.00	39.05	63.04	53	450	44.3	9,384
Kerala	56.04	67.39	104.05	12	87	86.2	8,924
Maharashtra	10.16	52.61	n.a.	47	336	52.3	15,457
Punjab	28.85	69.55	n.a.	51	369	50.4	16,044
Tamil Nadu	20.88	71.94	85.39	53	376	51.3	10,222
<i>Newly Formed States</i>							
Arunachal Pradesh	0.00	-319.39	n.a.	n.a.	n.a.	n.a.	n.a.
Himachal Pradesh	22.53	61.53	n.a.	n.a.	n.a.	n.a.	n.a.
Manipur	72.25	-101.80	n.a.	n.a.	n.a.	n.a.	n.a.
Meghalaya	0.00	-11.71	n.a.	n.a.	n.a.	n.a.	n.a.
Mizoram	8.79	-33.37	n.a.	n.a.	n.a.	n.a.	n.a.
Nagaland	14.01	5.51	n.a.	n.a.	n.a.	n.a.	n.a.
Sikkim	0.00	37.41	n.a.	n.a.	n.a.	n.a.	n.a.
Tripura	0.00	-78.35	n.a.	n.a.	n.a.	n.a.	n.a.

n.a. – not available.

It is interesting to see if fiscal distress correlates with indicators of socio-economic development. Table 8 clearly shows that infant mortality and maternal mortality tend to be lower in slow-reforming States, while per capita NSDP and female literacy tend to be higher in fast-reforming States. For example, Haryana has the highest infant mortality rate among the fast-reform States, which is lower than every slow-reform State except one (West Bengal). Likewise, Karnataka has the highest maternal mortality rate among fast-reforming States, which is lower than every slow-reforming State except for West Bengal. Similar patterns are evident for female literacy and per capita NSDP.

In summary, based on these data it would appear that Uttar Pradesh is representative of a slow-reforming State and Karnataka is typical of a fast-reforming State. Therefore, conclusions

drawn from field visits by the Team about the need for particular interventions in Uttar Pradesh and Karnataka should apply to other States in the same category. Of course, there always will be State specific idiosyncrasies. For example, Uttar Pradesh does not express a desire for technical assistance and capacity building in tax administration, but other slow-reforming States may desire it.

The newly formed States require special mention. The Team could not obtain data for the “newly formed States,” therefore they are not included in Table 8. In addition, we have included many of the Northeastern States in the “newly formed State” category. Although the data in Table 8 are incomplete, the fiscal distress indicators suggest that the Northeastern States are in relatively good fiscal condition. They are placed in the “newly formed State” category because they are generally believed to lack capacity and to rate low relative to other States in terms of socio-economic development.

In devising a State strategy USAID also may wish to keep in mind the relative merits of a State’s objective needs, perceived needs, receptivity to adopting fiscal management reforms and absorptive capacity. For example, Jharkhand ranks high relative to the other States in terms of receptivity to reforms. Officials there clearly recognize the need to implement fiscal management reforms. Furthermore, the officials of Jharkhand make a very convincing case that since it is a newly formed State they have very little capacity for fiscal management within the government. They also are very enthusiastic about the prospect of USAID assistance in support of fiscal management reforms. On the hand, Jharkhand enjoys a budget surplus, so the objective needs of the State, as opposed to the perceived needs, may not be as high as in other States. In the case of Jharkhand, the goal of implementing fiscal management reforms would be to prevent the State from falling into the debt trap in which the others find themselves.

In contrast, Uttar Pradesh ranks relatively high in terms of objective need for fiscal management reforms simply due to its population and the severity of the fiscal problems it faces. Nevertheless, Uttar Pradesh ranks relatively low in terms of receptivity to and perceived need for reform. Consequently, Uttar Pradesh’s absorptive capacity may be low relative to Jharkhand. Meanwhile, Karnataka ranks high in terms of receptivity to fiscal management reforms and absorptive capacity, however, it ranks relatively low, in terms of objective needs. Although the fiscal condition of Karnataka is quite poor, it is committed to reforms and is already receiving substantial assistance from the WB.

Additional criteria that USAID may wish to consider while devising a State strategy is the influence of the levels of official corruption and administrative efficiency in each State on absorptive capacity for and impact of fiscal management reforms. More specifically, some believe that the States of India can be categorized according to the four cells of Matrix 1 below. For example, Kerala may be an example of a State characterized by a low level of official corruption and a low level of administrative efficiency. If so, then Kerala would fall into Cell 1 of the Matrix. Tamil Nadu, on the other hand, may fall in Cell 2: States characterized by low levels of official corruption and high levels of administrative efficiency.

Generally speaking, States with high levels of administrative efficiency will rate high in terms of absorptive capacity because they will be able to implement reforms in a timely and

orderly fashion relative to States with low administrative capacity. While States with high levels of official corruption may be able to implement management reforms, the result of such reforms may simply translate into more efficient corruption rather than a favorable impact, like higher quality of public expenditure. In other words, USAID may wish to consider whether it would prefer to work in States falling in Cell 1, which have low absorptive capacity, but more likely to result in favorable impacts, as opposed to those in Cell 3 with high absorptive capacity, but more likely to result in unfavorable impacts.

Matrix 1: State Categorizations

	Low efficiency	High efficiency
Low corruption	Cell 1 Low capacity Favorable impact	Cell 2 High capacity Favorable impact
High corruption	Cell 4 Low capacity Unfavorable impact	Cell 3 High capacity Unfavorable impact

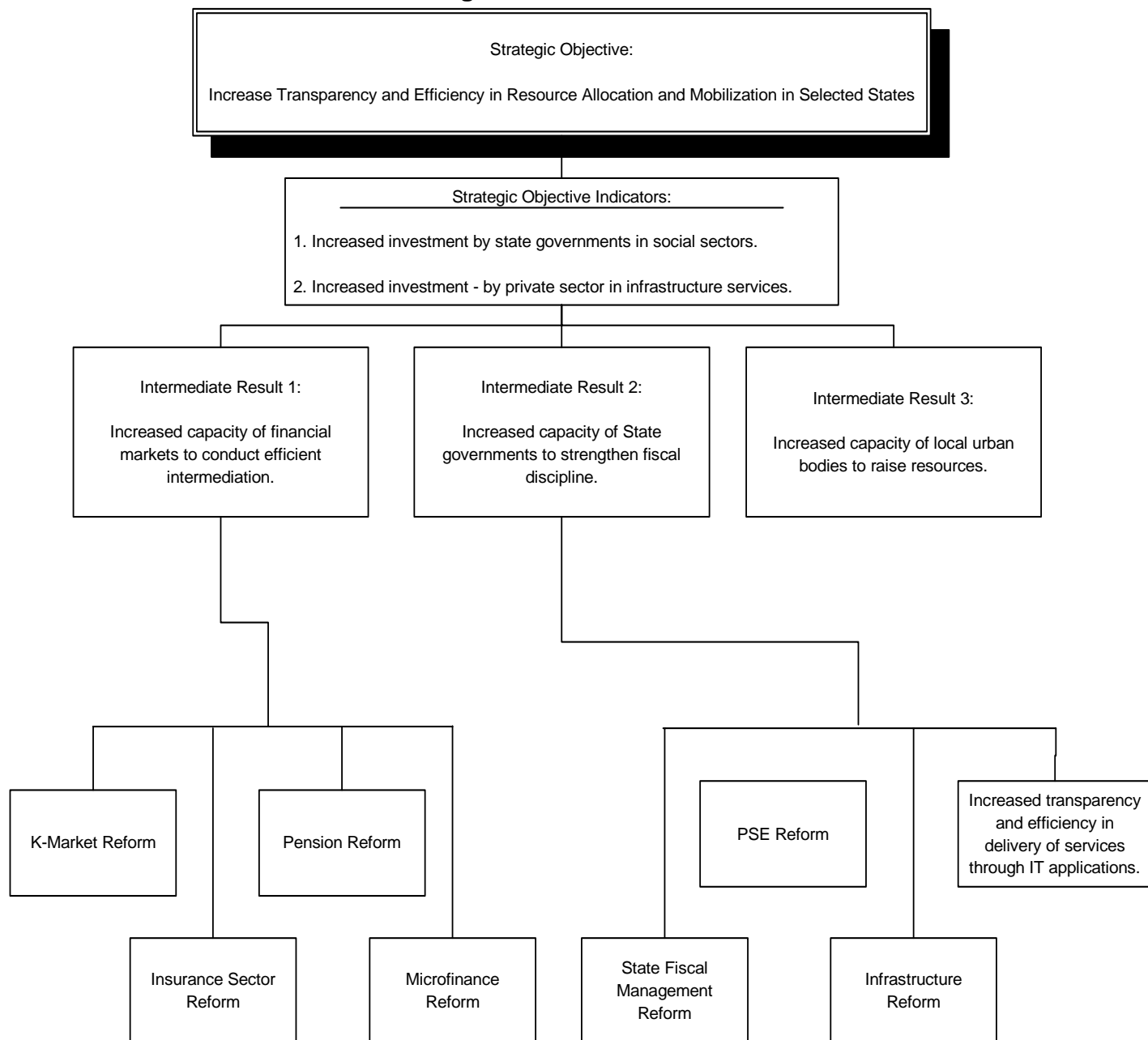
Finally, USAID may wish to consider what kind of impact they would like to have when devising a State strategy. For example, USAID intervention in support of fiscal management reform may only make a 1 percent difference in a State like Uttar Pradesh. Since it is such a large State population-wise, however, this small difference may translate into a very large total impact relative to making a 15 percent difference in a much smaller State like Jharkhand.

The Relationship Between the IR and the SO

We conclude this Assessment by briefly describing how increasing the capacity of State governments to strengthen fiscal discipline, which is a proposed Intermediate Result (IR) in the Mission's Five-Year Strategy, relates to the high-order Strategic Objective (SO) to increase transparency and efficiency of resource allocation and mobilization. The SO and IR for the Economic Growth Activity are summarized in Figure 1 below. It is important to note, however, that this organizational chart is based on our understanding of a draft version that may very well have changed since our departure.

There are major structural weaknesses in State finances that are preventing them from effectively allocating and mobilizing resources. Investment in physical and social infrastructure is the major victim of the lack of fiscal discipline among the States. Currently, Indian State governments are caught in a vicious cycle of fiscal crises, low growth and deteriorating social and economic amenities. Although the State deficit stems from the failure of the States to mobilize sufficient resources, the State response to the resulting fiscal stress is harmful to the future prospects of India. For example, the bulk of State resources are going to the payment of salaries, pensions, subsidies to public sector undertakings, in particular power, and interest on mounting State debt. Furthermore, borrowing to cover Revenue Deficits reduces the capacity of States to borrow for important capital investments in both social and physical infrastructure. Reduced investment in infrastructure, especially social infrastructure like health and education, adversely affect the poor who are dependent on public services. Increased borrowing by the government also limits the private sector's ability to raise funds for investment.

Figure 1: Economic Growth



These structural weaknesses in State finances stem from decisions taken by the States and reflect the absence of forward looking capacity to analyze the fiscal consequences of policy, regulatory and procedural decisions. The primary focus of State governments is on administrative approval of schemes/programs and the level of disbursement. Little emphasis is placed on cost-benefit analysis of programs, the quality of expenditure and attainment of objectives. For example, the Department of Finance in Uttar Pradesh with a population of 166 million (equivalent to the seventh largest nation in the world) does not have an institutional structure dedicated to fiscal analysis to inform decision-making on revenue and expenditure policies of the State. Poor management information systems exacerbate this weakness. In Karnataka, one of India's more reform-minded States and the 'Silicon Valley' of India, the government's statistical department for the entire State has only three computers.

Other weaknesses related to State fiscal management include: (a) poor compliance and lack of innovative approaches to tax and non-tax resource mobilization; (b) continued support of unsustainable patterns of investment and expenditure; (c) inefficiency of public sector enterprise performance (that are currently supported through large State subsidies); and (d) inability to recover costs from public sector enterprises. Much of the above are the result of an absence of analytical capability and poor MIS. Capacity building to support of State fiscal management reforms are critical, if States are to restructure their finances with a minimum adverse impact on the poorest members of society.

Finally USAID asked the Team to relate the IR - increasing the capacity of State governments to strengthen fiscal discipline - to good governance. Box 1 below provides a handy working definition of good governance.

Box 1

"Good governance is epitomized by predictable, open and enlightened policy making, a bureaucracy imbued with a professional ethos acting in furtherance of the public good, the rule of law, transparent processes and a strong civil society participating in public affairs." Source: *United Nations website*.

The Team has given priority to three potential interventions: establishing a fiscal analysis unit, strengthening MIS capabilities by modernizing treasury operations and developing a HR database and increasing the capacity of State government to produce regular and timely socio-economic indicators by district. In our opinion, these potential interventions are supportive of good governance.

First, establishing a fiscal analysis unit will make the budget formulation process more predictable, open and enlightened. The failure of State government to evaluate the near term fiscal implications of policy choices is clearly not enlightened policy making or in furtherance of the public good. As previously discussed, actual State expenditures bear little resemblance to planned expenditures as described in the budget. Poor budget execution is not only evidence of poor management, but it also undermines the ability of civil society to participate meaningfully

in public affairs. In order for civil society to participate in public affairs, it is helpful if government processes are transparent. For example, it is valuable to know how much the government is spending on education and health, the number of employees, etc. The State budget document is the public's primary source of information on the activities on State government.

Second, modernizing State treasury operations will improve the quality of public expenditure by ensuring that money is spent as intended and increase transparency, and thereby strengthen civil society, by ensuring that there is an appropriate correspondence between the budget and actual expenditures. In addition, making State budget information more accessible to the public will help strengthen the role of civil society in public affairs. This could be accomplished by, for example, increasing the general fiscal knowledge of NGOs and journalists. Finally, having access to key social-economic indicators on a regular and timely basis will increase transparency and strengthen civil society.

ANNEX I

Approach

Task/Work Requirements

The following issues and related set of tasks form the substance of the work that will be completed by the contracted team of consultants. The states selected as test targets for the team's analytic work are: 1) Karnataka - identified as a pro-reform state; (2) Uttar Pradesh (U.P.) - identified as a slow-reform state; and (3) Jharkand - a newly formed state.

Issue 1: Enhanced capacity of states to increase efficiency, transparency and accountability in resource mobilization.

For the last few years, tax revenues of states have remained stagnant while the tax systems that generate these revenues are, for the most part, inefficient and distorted. As a general rule, approximate two-thirds or 66 percent of the total revenue of state governments is by the states with the other third or 34 percent coming from tax revenues that are raised by the center and then transferred to the states. There are numerous problems in the state tax regimes, including: their cascading nature; the multiplicity of rates; the exportation of taxes; and poor compliance.

Task 1 - The subcontractor will analyze the existing tax and non-tax administration, structure and systems in the three selected states and develop a list of current constraints to efficient, transparent and accountable mobilization of revenues, including reference to the VAT and Modified VAT. The analysis will also address the state government's (especially the state finance and planning ministries') research, planning and analytical capabilities, as well as the Management Information Systems (MIS) that are used to monitor and assess tax and non-tax revenue mobilization.

Task 2 - The subcontractor will recommend a feasible course of actions that will mitigate the negative impact of such existing constraints. The objective of such a course of actions to USAID for its consideration will be to improve the tax and non-tax administration, structure and systems so as to increase overall efficiency, transparency and accountability. The suggested course of actions will include reference to the Value Added Tax (VAT) and the Modified VAT (MODVAT) systems that are currently being introduced by the Government of India (GOI).

The subcontractor shall also address the adequacy of existing training infrastructure (both in terms of quality and outreach) at the state level. The proposed course of corrective actions to USAID for its consideration will be aimed at strengthening the institutional capacity of the relevant state government departments and ministries to establish a more efficient, transparent and accountable tax and non-tax administration, structure and systems.

The subcontractor shall address the state government's research, planning and analytical capabilities, as well as the management information systems that are used to monitor and assess tax and no-tax mobilization.

Based on the above, the subcontractor shall recommend a program of technical assistance and training for USAID to consider in order to help improve the tax administration, structure and systems in each of the three selected states. While making recommendations, the subcontractor should identify the following: U.S strength and expertise in this area; potential synergies between different Mission Strategic Objectives that such an intervention will promote; and the potential to leverage other donor activities in this area.

Issue 2: Improved capacity of states to increase efficiency, transparency and accountability in expenditure management.

Public expenditures pay primarily for wages, salaries, pension, and interest payment on old debt – a large part of which go towards supporting the burgeoning subsidies. Wages and salaries, as a proportion of total state expenditures, have been rising steadily over the past decade. The State Governments' wage bill is estimated to have increased by 2-4 percent as a percentage of State GDP, over the last decade. As a result of this, the state governments are increasingly unable to sustain the level of borrowing at markets rates to finance these fiscal deficits.

The lack of any real social security system throughout India is largely responsible for the resistance to changing the systems that is common among workers and unions. They fear job loss as a result of the downsizing that would occur under a program of fiscal reforms. Therefore, the development and establishment of safety nets such as unemployment insurance schemes and pension fund schemes, is an urgent requirement.

Pensions weaken the fiscal position of both the Center and the States. In fiscal year 2000-2001, payment to such schemes consumed more than 15 percent of Central Government revenues, in fact, pensions have been the fastest growing item in the state budgets over the last decade. Civil servants continue to be covered by non-contributory, defined benefit schemes. Currently, the Central Government and an increasing number of state governments are struggling with the mounting cost of pensions for their employees. In addition, the privatization process has exposed a separate set of pension liabilities of the state-owned enterprises. For example, though the data has not yet been fully developed, independent actuarial valuations of the Electricity Board pension schemes of both Andhra Pradesh and Uttar Pradesh revealed liabilities equivalent to 3-4 percent of State GDP. Recently, a proposal to enable new civil servants to join private pension schemes has been suggested. Unlike voluntary retirement savings, mandated contributions to private sector schemes imply greater liability on the part of the Government.

Task 3 - The subcontractor shall analyze the existing expenditure management structure, processes and systems in the three selected states. The analysis will include how wages, salaries, pension, interest payments and subsidies (implicit/explicit) are calculated, analyzed, tracked, assessed and coordinated between the various departments of relevant ministries and with respect to treasury operations. Documentation of the current liabilities and future fiscal burdens of current and future expenditures for above items will help to demonstrate the magnitude of the problem involved.

Out of this analysis the subcontractor shall develop a comprehensive list of existing constraints to a more efficient, transparent and accountable expenditure management structure. The analysis will also address the state government's (especially the state finance and planning ministries') research, planning and analytical capabilities, as well as the MIS capabilities to track, monitor and assess expenditure management.

Task 4 - The subcontractor shall identify a feasible course of actions for USAID's consideration aimed to mitigate the negative impact of such existing constraints, so as to improve the expenditure management system and increase efficiency, transparency and accountability. This identification will include a discussion of the expenditure management structure, processes, systems and controls, strengthening of treasury operations, improved debt management; and budgeting. The subcontractor will also address the adequacy of the existing training infrastructure (both in terms of quality and outreach) to help strengthen the institutional capacity of the relevant government departments and ministries.

Based on the above, the subcontractor shall recommend a program of technical assistance and training for USAID to consider in order to help improve public expenditure management system and increase efficiency, transparency and accountability in each of the three selected states. While making recommendations, the subcontractor should address the following: U.S strength and expertise in this area; potential synergies between different Mission Strategic Objectives that such an intervention can promote; and the potential to leverage other donor activities in this area.

Issue 3: Enhanced capacity of states to better coordinate revenue allocation and expenditure management between the state finance and planning ministries and the public sector enterprises (PSEs) and public sector infrastructure service providers to reduce the burden on the state fiscal budgets.

Throughout the 1970s and 1980s, the states expanded investments in physical infrastructures and social services without establishing appropriate mechanisms for cost recovery and for maintaining these assets over time. Prices charged for power, water, irrigation, higher education and other services are now commonly a small fraction of production costs. Low user charges for public services have resulted in a burgeoning of the subsidy bill to support poorly managed and heavily subsidized PSEs. The power sector is a clear example – subsidies amount to 1-2 percent of GDP and contribute up to 50 percent to most state fiscal deficits. As a result, the central government subsidizes losses of around \$1.7 billion a year. Although, the public sector dominates infrastructure service provision, most public sector units do not provide high quality, timely or cost efficient services.

Further, there are 1000 state-level PSEs that impose a serious fiscal burden on the states and the center. Inefficiently managed PSEs also constrain private sector efficiency since the private sector sources inputs and infrastructure services from PSEs.

Capacity must be built within the public sector to operate at market efficiencies and strong public-private partnership must be promoted. States have often used guarantees to bypass the 'hard budget constraint' that they face. Outstanding guarantees have grown at a fast pace

during the 1990s. There is an urgent need to curtail the reliance on guarantees in order to prevent the non-transparent increase in government liabilities and over burdening future generations with debts.

Task 5 - Based on secondary material and field visits, the subcontractor will document for the three selected states, the constraints to reducing the fiscal burden on the state budgets that are imposed by state level PSEs and the state infrastructure service providers.

With respect to PSEs, the subcontractor shall document: The number of PSEs in each state; the sectors covered by the PSEs; the size of PSEs by investment and employment; the estimated burden (subsidy, wages, salaries and pensions) on the states fiscal deficit; the current pricing policies that are followed; and any existing or planned programs for disinvestment/privatization of such PSEs and any regulatory impediments to privatization.

With respect to the infrastructure sector, the subcontractor shall document: The existing methods of financing road projects; the current pricing structure; and the status of any existing private sector participation in road projects. As part of this element of the analysis, the subcontractor should also focus on the research, planning and analytical capabilities of public sector infrastructure policy makers and service providers. The subcontractor shall also analyze the existing and needed MIS capabilities of such entities.

The subcontractor shall document the pension schemes and other social safety net structures in place in each state and the attitude toward and need for reform.

The AYSPS team will recommend possible technical assistance and training activities to build the capacity of the state ministries of planning and finance to coordinate revenue allocation and budget processes between ministries.

Based on this identification process, the subcontractor shall recommend possible technical assistance and training activities for USAID to consider aimed at building capacity of the state ministries of planning and finance to better coordinate revenue allocation and the budget process between the ministries and the PSEs and the public infrastructure service providers at the state level. The subcontractor also shall analyze the existing and needed MIS capabilities of such entities. While making recommendations, the subcontractor will address the following: U.S strength and expertise in this area; potential synergies between different Mission Strategic Objectives that such an intervention can promote; and the potential to leverage other Donor activities in this area.

Issue 4: USAID/India five-year action plan

Currently, USAID/India has no direct presence in the state fiscal management reform process. There are, however, on-going programs in the Mission that address issues related to cost recovery, subsidies, user costs, the ability of local governments to mobilize resources, the approaches to increasing efficiency, transparency and accountability of the infrastructure sector (road) and local governments.

Task 6 - The subcontractor shall recommend alternative approaches for USAID's consideration that will strengthen the fiscal management reform efforts at the state level. This will include tested options to mitigate the negative impact of the fiscal management reform at the state level, including reform of pension schemes, unemployment insurance and the social safety net. In making the recommendations, the subcontractor will take into consideration: (a) the key gaps and the niche areas for intervention; (b) the nature of intervention (technical assistance and/or training, etc.); (c) possible suitable implementing partners for USAID; (d) a time frame for suggested interventions; and (e) some possible performance indicators for measuring the achievement of targeted results and the impact of interventions on gender equity issues.

The assessment shall include tested options to mitigate the negative impact of the fiscal management reforms, including reform of pension schemes, unemployment insurance and the social safety net.

As part of this recommendation process, the subcontractor shall briefly describe what major international donors are doing in the area of state fiscal management reform, including infrastructure sector reform in the area of roads and PSE privatization/reform. The subcontractor shall also recommend possible approaches to measuring the impact of such interventions on gender equity issues.

Methodology

Based on the tasks described above the subcontractor will write an assessment that provides the following elements:

- a program of technical assistance and training to help improve tax administration structures and systems in each of the three selected states.
- a program of technical assistance and training to improve the expenditure management system and increase efficiency, transparency and accountability.
- a program of technical assistance and training to build the capacity of state ministries of planning and finance to better coordinate revenue allocation and the budget process between the ministries, PSEs and the public infrastructure service providers. The team also will analyze the existing and needed MIS capabilities of such entities.
- a program of tested options to mitigate the negative impact of the fiscal management reforms, including reform of pension schemes, unemployment insurance and the social safety net.

The team will take into account: key gaps and niche areas for intervention; the nature of intervention (technical assistance and/or training); possible suitable implementing partners for USAID; and some possible performance indicators for measuring the achievement of targeted results and the impact of interventions on gender equity issues.

The team will identify niche areas by considering the following criteria. First, the niche areas should be in areas of real as opposed to marginal need. Second, recommended interventions should have the support of the leadership of the states. USAID, the assessment team and other donor organizations may believe that there is a tremendous need to restructure PSEs and increase cost recovery. Unless the political leadership supports such interventions, however, the intervention will not be successful. There must be an appropriate correspondence between USAID's view of a real need in a given state and the priorities established by the state. Third, USAID's interventions should be complementary to the activities of the center, the state and other donor organizations. There is no reason for USAID to compete with and/or duplicate the effort of other international donor organizations in a given state. Fourth, the U.S. should have a comparative advantage in providing the technical assistance or training. There may be cases in which other countries have a greater capacity than the U.S. to conduct certain types of technical assistance.

Finally, the team must synthesize and weigh the analysis of the three states and formulate a common program. The formulation of a common program will depend in large part on the niche areas that are identified. It is likely that newly formed states will require a different program of support than a pro-reform state. Similarly, a slow reform state may see the writing on the wall and wish to follow the successes of a pro-reform state in addressing some of the fiscal issues described above. Thus, the team must weigh the needs and capacities of these three types of states in order to formulate a technical assistance and capacity building program. In all likelihood, the recommended program of interventions will have many common elements, but there also may be unique circumstances that call for customizing the intervention to suit the condition of individual states. In part, the unique circumstances may include whether the state is pro-reform, slow reform or a newly formed state.

ANNEX II

Overview of India's Fiscal Situation

Introduction

Public expenditure, broadly defined as the total expenditure incurred by governments at national level and sub-national levels, account for a considerable share of national income in any country. In India, this share is about one-third of the national income. Indeed, as against the general belief in this country, the share of public expenditure in developed market economies, as a proportion of national income, is higher in most cases. The issue of concern here is not the level of public expenditure in India, but the kind of public expenditure and the way it is financed. After a detailed discussion of the overall finances of the Center and the States in Part 1, Part 2 of the study focuses briefly on the government finances of individual States.

PART 1

A twenty-year time series of Government expenditure at the Center and the States is presented in Table II.1. The combined total expenditure given in the last column of the table represents the total public expenditure in the country except that it does not include the resources raised by the local bodies for their own expenditure which is estimated to be just over one percent of GDP. The broad trend over the two decades indicates that while the government expenditure as a share of GDP had been increasing in the 1980s to peak in 1986-87, the trend got reversed subsequently. However, an upward trend is discernable since 1996-97.

Table II.1: Government Expenditure as a Share of GDP (in Percent)

Year	<u>Center</u>			<u>States</u>			<u>Combined</u>		
	Revenue	Capital	Total	Revenue	Capital	Total	Revenue	Capital	Total
1981-82	9.1	5.8	14.9	10.1	3.6	13.7	19.2	9.4	28.6
1982-83	9.9	6.4	16.3	10.7	3.5	14.2	20.6	9.9	30.5
1983-84	10.1	6.0	16.2	10.8	3.3	14.2	20.9	9.3	30.2
1984-85	11.2	6.5	17.7	11.5	3.4	14.8	22.7	9.9	32.6
1985-86	12.1	6.7	18.8	11.7	3.2	14.9	23.8	9.9	33.7
1986-87	13.0	7.0	20.1	12.2	3.3	15.5	25.2	10.3	35.5
1987-88	13.0	6.2	19.2	12.7	3.1	15.8	25.7	9.3	35.0
1988-89	13.2	5.9	19.0	12.3	2.6	15.0	25.5	8.5	34.0
1989-90	12.9	5.6	18.5	12.6	2.6	15.3	25.5	8.2	33.7
1990-91	12.6	4.5	17.1	13.2	2.5	15.7	25.8	7.0	32.8
1991-92	12.4	4.0	16.4	12.9	2.4	15.2	25.3	6.4	31.7
1992-93	12.4	4.0	16.4	12.9	2.4	15.2	25.3	6.4	31.7
1993-94	12.6	3.9	16.5	12.7	2.2	15.0	25.3	6.1	31.4
1994-95	12.1	3.8	15.9	12.7	2.7	15.4	24.8	6.5	31.3S
1995-96	11.8	3.3	15.1	12.3	2.3	14.5	24.1	5.6	29.7
1996-97	11.7	3.1	14.8	12.4	2.0	14.4	24.1	5.1	29.2
1997-98	12.3	3.5	15.8	12.5	2.0	14.4	24.8	5.5	30.3
1998-99	12.3	3.5	15.8	12.5	2.0	14.4	24.8	5.5	30.3
1999-2000(RE)	13.1	2.6	15.7	14.1	2.2	16.2	27.2	4.8	32.0
2000-01(BE)	12.1	2.5	14.6	12.6	2.1	14.6	24.7	4.6	29.3

Source: All figures except those for the last two years are audited figures from the office of CAG. Figures for the last two years are from Budgets.

The trend over time of the two components of public expenditure viz., Revenue and Capital have been somewhat different. While the growth in revenue expenditure in the 1980s continued unabated till early 1990s, the growth in capital expenditure was rather short-lived. Indeed, revenue expenditure as a percentage of GDP shows three distinct peaks, first in 1987-88, next in 1990-91 and last in 1999-2000. In contrast, the capital expenditure as a share of GDP peaked in 1986-87 and subsequently experienced a more or less continuous decline over the subsequent period. Indeed, the share of capital expenditure in government expenditure as a proportion of GDP has come down by more than half over the last 14 years.

While there are broad similarities in the trend experienced by government expenditure at the Center and the States, there are also certain distinct features. Total expenditure of the Center as a share of GDP increased in the 1980s to peak in 1986-87 and declined almost continuously in the subsequent years. This decline is essentially on account of a steep decline in the capital expenditure of the Center. The capital expenditure of the Center as a share of GDP was as much as 7 percent in 1986-87, which steadily declined to almost one-third that level by the end of the 1990s. The revenue expenditure of the Center, increased more or less, steadily during the 1980s to reach the peak in 1989-90 and thus gradually declined in the 1990s till 1996-97. This trend was reversed subsequently.

The total expenditure of the States showed much less variation over the twenty- year period under consideration. As a share of GDP, it increased gradually through the 1980s, declined somewhat in the 1990s but steeply increased in 1999-2000. Throughout the period under consideration, the level of State expenditure was below the corresponding figure for the Center, except in 1999-2000. While the level of revenue expenditure of the States has been normally higher than that of the Center, except for a few years in the late 1980s, the level of capital expenditure of the States has been invariably lower than that of the Center. The States have been showing a declining trend in capital expenditure similar to that of the Center but of a lower order. Revenue expenditure of the States showed increasing trend in the eighties, but remained more or less steadily subsequently, except for a spurt in 1999-2000.

A few observations about the overall trends discussed in the above paragraphs may be in order. The spurt noticed in revenue expenditure at the Center as well as in the States in late 1980s and again in late 1990s is mainly on account of salary revisions for the government employees consequent upon the recommendations of the Fourth Pay Commission and Fifth Pay Commission respectively. The steep decline in capital expenditure of the Center is partly due to a policy change in the financing of public sector undertakings (PSUs) of a commercial nature since the second half of the 1980s. The PSUs which were depending on sizeable equity capital and loans from the government for their investment funds till then, have been encouraged to depend more and more on their internal resources and capital market in the subsequent period.

Financing of State Government Expenditure

There is a clear imbalance between the expenditure responsibilities and the own revenue sources of the State governments. While provision of most of the social and economic services as well as general administrative services is in the domain of the State governments, the

major revenue sources are with the Center. As a result, substantial revenue transfers take place from the Center to the States as ordained by the Constitution and through the mechanism of Planning Commission. The revenue transfers from the Center account for about 40 percent of the total revenues of the States. This share has not changed substantially over the period.

Table II.2 presents the component-wise details of State revenues for two decades. Though the various components of the revenues of the States have been showing upward trend in the 1980s and somewhat downward trend, of late, the overall trends have been significantly subdued as compared to the trends noticed in the case of expenditure of the States as well as Central devolution remained in the narrow band of 7.2 percent to 8.2 percent of GDP throughout the period. Similarly, the total non-tax revenues of the States comprising of own non-tax revenues and Central grants remained between 3.1 percent and 4.3 percent throughout the period under consideration. While own tax revenue accounted for as much as 65 to 70 percent of the total tax revenues, own non-tax revenues accounted for less than 50 percent of the total non-tax revenues, on the average.

Table II.2: Components of State Revenues as Share of GDP (in Percent)

Year	Tax revenues			Own non-tax revenue	Non-tax revenues		
	Own Tax Revenue	Share of Central Taxes	Total Revenue		Central grants	Total non-tax revenue	Total revenues
1981-82	4.9	2.5	7.4	1.9	1.6	3.5	10.9
1982-83	5.0	2.5	7.5	1.9	1.8	3.7	11.2
1983-84	4.9	2.3	7.2	1.9	1.9	3.8	11.0
1984-85	5.0	2.4	7.3	1.8	1.9	3.7	11.0
1985-86	5.2	2.6	7.8	1.9	2.3	4.2	12.0
1986-87	5.3	2.7	8.0	2.0	2.2	4.2	12.2
1987-88	5.4	2.7	8.2	1.9	2.3	4.2	12.4
1988-89	5.3	2.5	7.8	1.8	2.3	4.1	11.9
1989-90	5.3	2.7	8.0	1.8	1.7	3.5	11.5
1990-91	5.3	2.5	7.8	1.6	2.2	3.8	11.6
1991-92	5.5	2.6	8.1	1.9	2.3	4.2	12.3
1992-93	5.3	2.8	8.1	1.7	2.4	4.1	12.2
1993-94	5.4	2.6	8.0	1.8	2.5	4.3	12.3
1994-95	5.5	2.5	8.0	2.1	2.0	4.1	12.1
1995-96	5.4	2.5	7.9	1.9	1.8	3.7	11.6
1996-97	5.2	2.6	7.8	1.7	1.7	3.4	11.2
1997-98	5.4	2.7	8.0	1.6	16.0	3.2	11.2
1998-99	5.3	2.3	7.6	1.4	1.7	3.1	10.7
1999-2000(RE)	5.6	2.4	8.0	1.4	1.8	3.2	11.2

Source: Reserve Bank of India (RBI)

A comparison of the revenue expenditure of the State governments as given in column 5 of Table II.1 and the revenue receipts of the State governments as given in column 8 of Table II.2 clearly indicates that the States enjoyed revenue surpluses at the aggregate level in the early 1980s; but since 1987-88 they have been experiencing revenue deficits on a continuing basis. It implies that the States have been forced to borrow beyond their requirements for capital expenditure. It is also well known that Center has been resorting to large-scale borrowings to meet its commitments including transfers to the States. Since late 1970s the Center has been

experiencing revenue deficits and as a result the borrowings of the Center have been significantly exceeding its capital expenditure.

Table II.3 presents the gross fiscal deficit (GFD) and revenue deficits (RD) of the Center and the States for a period of two decades since 1981-82. Throughout the 1980s the GFD of the Center have been raising upwards,. Indeed, a major objective of the economic reforms initiated in 1991, especially the stabilization policies adopted, was to contain these deficits measures. As column 2 of Table II.3 indicates, there was considerable success in bringing down the GFD of the Center since 1991-92, though the success in terms of the targeted reduction could not be achieved. Another matter of concern is that almost the entire reduction of GFD was achieved by cutting down the essential capital expenditure as there was hardly any reduction in revenue deficit since 1991-92 as indicated by column 5 of the table.

Table II.3: Gross Fiscal Deficit and Revenue Deficit as a Percentage of GDP

Year	Gross Fiscal Deficit			Revenue Deficit			Percentage share of RD in GFD		
	Center	States	Combined	Center	State	Combined	Center	State	Combined
1981-82	5.1	2.2	7.3	0.2	-0.8	-0.6	3.9	-36.4	-8.2
1982-83	5.6	2.2	7.8	0.7	-0.5	0.2	12.5	-22.7	2.6
1983-84	5.9	2.3	8.2	1.1	-0.1	1.0	18.6	-4.3	12.2
1984-85	7.1	2.6	9.6	1.4	0.4	1.8	19.7	15.4	18.8
1985-86	7.8	2.9	10.7	2.0	-0.2	1.8	25.6	-6.9	16.8
1986-87	8.4	2.4	10.8	2.5	0.0	2.5	29.8	0.0	23.1
1987-88	7.6	2.6	10.2	2.6	0.3	2.9	34.2	11.5	28.4
1988-89	7.3	2.7	10.0	2.5	0.4	2.9	34.2	14.8	29.0
1989-90	7.3	2.4	9.7	2.5	0.7	3.2	34.2	29.2	33.0
1990-91	7.8	2.7	10.6	3.3	0.9	4.2	42.3	33.3	39.6
1991-92	5.6	2.9	8.4	2.5	0.9	3.4	44.6	31.0	40.5
1992-93	5.4	2.8	8.2	2.5	0.7	3.2	46.3	25.0	39.0
1993-94	7.0	2.4	9.4	3.8	0.4	4.2	54.3	16.7	44.7
1994-95	5.7	2.7	8.4	3.1	0.6	3.7	54.4	22.2	44.0
1995-96	5.1	2.7	7.8	2.5	0.7	3.2	49.0	25.9	41.0
1996-97	4.9	2.7	7.6	2.4	1.2	3.6	49.0	44.4	47.4
1997-98	5.9	2.9	8.8	3.1	1.1	4.2	52.5	37.9	47.7
1998-99	6.4	4.2	10.6	3.8	2.5	6.3	59.4	59.5	59.4
1999-2000	5.6	4.6	10.2	3.8	2.9	6.7	67.9	63.0	65.7
2000-01(RE)*	5.5	4.4	9.9	4.0	2.4	6.4	72.7	54.5	64.6

* Note: RE: (Revised Estimates)

Source: Based on RBI statistics

Structural adjustment program and fiscal consolidation initiated in 1991 were essentially at the Center only and as such the deficit indicators of the States remained rather unaffected as can be seen from columns 3 and 6 of Table II.3. While the GFD of the States remained more or less stable at around 2.5 to 3.0 percent of GDP for the better part of the Nineties, there was a quantum jump during the last three years. This spurt was essentially on account of the additional revenue outgo on account of the salary revision and the accompanying arrears payment. This is also reflected in the steep increase in the revenue deficits of the States during the last few years as reflected in column 6 of the Table.

One can, perhaps, argue with some justification that public borrowing as such is not bad, provided the borrowed funds are invested in building up assets which will generate incomes to service the debts or at least generate economic growth which will boost the revenue earnings of the government to service the debt. However, if a sizeable share of the borrowings are used up in meeting the current revenue gap of the government, it is a matter of serious concern. Indeed, this has been precisely happening in India, both at the level of the Center and the States since the mid-eighties. This is amply evident from the trend shown by the figures in column 8, 9 and 10

of Table II.3. Column 8 indicates that RD as a share of GFD increased from around 25 percent in 1985-86 to over 72 percent in 2000-01. This implies that while 15 years ago 25 out of 100 rupees borrowed were used up in meeting the current revenue gap, now over 72 out of 100 rupees of such borrowings are used up in meeting the revenue gap. In the case of the States the deterioration is even more tragic. In 1986-87, there was no RD implying that the entire borrowing was available for capital expenditure. The fiscal situation of the States steadily and decidedly worsened over the past 14 years and now more than half of the borrowings of the States is used up in meeting the current revenue gap. Since 1998-99, the combined revenue gap of the Center and States is 60 percent or more of the GFD.

Alarming Deterioration of State Finances in Recent Years

During the 1990s the overall fiscal position of the States had been improving, though modestly, till 1996-97. The situation, however, went out of control since 1997-98. The outstanding debt of all States together more than doubled from Rs.243000 crore in March 1997 to about Rs.500000 crore in March 2001. State Debt:GDP ratio, which was over 19 percent in the early 1990s came down to under 18 percent by 1996-97, but shot up to over 23 percent in four years by 2000-01.(Table II.4).

Table II.4: A Few Key Indicators of State Finances

Year	Debt	Average interest	Interest payments	Pension	Interest+ Pension	Tariff recovery
1990-91	19.47	9.20	1.53	0.63	17.47	
1991-92	19.37	9.92	1.68	0.57	17.59	
1992-93	19.04	10.46	1.77	0.59	17.61	82.2
1993-94	18.63	11.11	1.84	0.59	18.52	78.3
1994-95	18.27	12.13	1.92	0.61	20.57	78.3
1995-96	18.72	11.89	1.86	0.66	21.50	77.4
1996-97	17.88	11.56	1.88	0.72	23.07	76.7
1997-98	18.53	12.37	1.98	0.76	23.77	75.2
1998-99	19.36	12.76	2.03	0.92	28.30	70.7
1999-2000	21.57	13.31	2.35	1.15	36.63	70.2
2000-01	22.77	12.97	2.48	1.09	36.61	69.8

Notes: Debt: Debt of States as a percentage of GDP

Average interest: Average interest cost of debt to States

Interest payments: Interest payment of States as a percentage of GDP

Pension: Pension payments of States as a percentage of GDP

Interest+ Pension: Interest payments + pension payments of States as a percentage of revenue receipts

Tariff Recovery: Recovery through tariff as a percentage of cost – State electricity Bards (combined)

Source: Based on RBI statistics

Average interest cost of State borrowings, which was 9.2 percent in 1990-91, steadily increased through the 1990s to reach 13.3 percent in 1999-2000, but decreased somewhat subsequently. The combined effect of growth in debt stock and rise in the cost of borrowing has been a crushing growth in interest burden. The interest liability of all States, together, increased more than six-fold during the last decade from less than Rs.9000 crore to more than Rs.54000 crore. Indeed, the incremental interest burden in the last year of the decade was more than the absolute interest burden at the beginning of the decade. (Table II.4).

The outstanding debt and the associated interest burden discussed above are the direct liabilities of the States. Besides, the contingent liabilities on account of State guarantees to borrowings by the parastatals have also been mounting of late. According to Reserve Bank of India, such liabilities have already crossed Rs.125,000 crore by March, 2001 and are still growing at a fast rate. Servicing of a major share of such debts devolve on the State exchequer.

Several factors have contributed to this alarming development. The main reasons have been the inability of the States to contain the growth in revenue expenditure and at the same time their reluctance to raise additional revenues. Interest payments and salary and pension liabilities have registered unprecedented growth. Interest burden as a percentage of revenue receipts has gone up from 13 to over 22 in the last decade. This was the combined effect of increase in the debt burden and increase in the cost of funds. (Table II.4).

The salary burden, which as a share of revenue receipts, had been going down till 1996-97 has shot up since 1997-98. The salary bill of the States has more than doubled in three years since then. This was the result of the hefty pay hike by the States in the wake of Central Government pay revision based on Fifth Pay Commission's recommendations. The combined salary bill of all States had crossed Rs.100,000 crore in 1999-2000 which worked out to over 5 percent of GDP. Besides the emoluments of their own employees, the State governments provide grants in aid for salaries of teachers of all aided educational institutions and employees of local bodies as also other assisted organizations which would work out to not less than another 2 percent of GDP.

Pension liabilities have been the fastest growing item of revenue expenditure in the States in recent years. As a result of the very generous pension benefits, which accompanied the pay revision, the pension outgo doubled in just two years from Rs.11600 crore in 1997-98 to over Rs.22600 crore in 1999-2000. Pension payments are likely to continue to grow faster than the salary bill in the coming years in view of the fact that life expectancy will be increasing and the number of pensioners will be growing at a faster rate than the number of employees; a fall out of the steep increase in the number of employees in government and government aided institutions in the seventies. (Table II.4).

Interest payment and pension liability are committed expenditure, which are the legacy of the past. These two have been the fastest growing components of revenue expenditure in the recent past. They preempt more than a third of revenue receipts of the States now. Indeed, their combined share, as a percentage of revenue receipts, more than doubled during the last decade (Table II.4). While the principal components of revenue expenditure went on escalating rapidly, the growth of revenue receipts has been sluggish. The principal items of revenue receipts are States own tax revenues and non-tax revenues, share in Central taxes and Central grants on plan and non-plan account.

States' own tax revenues, as a share of GDP remained stagnant at around 5.4 percent during the nineties unlike in the previous decades when Tax:GDP ratio had been steadily moving upward though slowly. Factors mainly responsible for the slow growth have been the tax incentives offered by the States to attract industries to their respective territories and the general economic recession, especially the slow down in industrial growth since 1997-98.

Non-tax revenues of the States as a share of GDP have been steadily coming down. User charges for non-merit goods and services are not sufficient even to cover more than a small fraction of the operation and maintenance costs. This is one area where 'competitive populism' has taken a heavy toll of public revenue. Power sector is the classic example of this phenomenon (Table II.4).

A recent study (Budgetary Subsidies in India by National Institute of Public Finance and Policy, October 2001 commissioned by the Planning Commission) indicates the heavy burden of budgetary subsidies on the State finances. According to this, budgetary subsidies of the State governments amounted to 8.8 percent of the GDP and about 96 percent of their revenue receipts. After adjustment for salary arrears paid in 1998-99, the subsidies are estimated at 8.38 percent of GDP for that year. Relative to the GDP, aggregate budgetary subsidies of the State governments have fallen in 1998-99 as compared to the earlier available estimates for 1994-95. The recovery rate also has fallen. This can only be explained in terms of a fall in expenditure on social and economic services relating to GDP.

Agriculture and Irrigation sectors account for the largest share of State subsidies, followed by elementary education, energy, secondary education and medical and public health. Per capita subsidies generally show a regressive pattern; the higher the per capita income of a State, the higher are the per capita subsidies.

The share of Central tax revenues devolving to the States during the second half of the nineties fell significantly short of the projections of the Tenth Finance Commission (TFC) reflecting the decline in Tax:GDP ratio of the Center since 1997-98. Plan grants to the States as a proportion of GDP has been falling for the same reason. Non-plan gap grants recommended by the TFC tapered off to zero by 1999-2000. This was based on the assumption that revenues of the States would steadily improve during the TFC's award period through improvement in States' own revenues and increased Central transfers. In the event, not only overall revenues of the States did not improve but in fact deteriorated sharply. And this happened during a period when revenue expenditures had been soaring. The States reacted to the emerging situation by borrowing recklessly to fill the revenue gap rather than making efforts to contain expenditure or to augment revenues.

PART 2

The overall picture as depicted in Part 1 does not reveal the vast inter-State variation in fiscal situation. There is hardly any State government which has not experienced fiscal deterioration since 1997-98. The situation, however, varies substantially across the States. While a few States have taken steps to correct the fiscal crisis, some are facing a near fiscal collapse. Others fall in between. An attempt is made in the following paragraphs to briefly analyze the Statewise position.

The interest liabilities of the States have grown phenomenally over the last decade from about Rs.8500 crore in 1990-91 to about Rs.58,000 crore in 2001-02. The growth in the recent few years has been particularly high which is a reflection of the heavy borrowings resorted to by

the State governments in the wake of salary revision for their employees. Table II.5 gives the Statewise picture.

Table II.5: State's Interest Payments

State	1990-91	1994-95	1997-98	1998-99	1999-2000	2000-01(RE)	2001-02(BE)
Andhra Pradesh	589	1256	2153	2644	3101	3915	5067
Arunachal Pradesh	16	35	60	71	80	124	N.A
Assam	262	589	639	521	956	996	1288
Bihar	683	1595	2062	2412	2867	2374	2736
Goa	30	69	118	144	178	213	262
Gujarat	539	1191	1884	2262	2808	3498	4100
Haryana	242	487	820	997	1357	1531	1790
Himachal Pradesh	110	223	372	498	597	892	N.A
Jammu & Kashmir	180	629	815	665	845	862	1001
Karnataka	436	871	1394	1617	2012	2417	2849
Kerala	341	820	1286	1446	1952	2108	N.A
Madhya Pradesh	513	1094	1660	1835	2139	2404	2459
Maharashtra	881	1760	2904	3673	4884	5585	6415
Manipur	32	52	79	91	132	159	N.A
Meghalaya	18	45	61	69	96	131	157
Mizoram	32	30	66	74	94	105	121
Nagaland	31	67	113	135	152	194	225
Orissa	365	787	1292	1485	1238	2318	3020
Punjab	332	1244	1849	2317	2637	2445	2813
Rajasthan	499	1036	1897	2243	2825	3378	3980
Sikkim	10	26	41	52	68	83	83
Tamil Nadu	456	1090	1763	2122	2711	3000	3300
Tripura	38	76	120	141	185	219	233
Uttar Pradesh	1299	3089	4689	5517	6553	8402	9309
West Bengal	627	1327	2410	2950	4169	5575	6739
Total	8561	19488	30547	35981	44636	52928	57947

Source: RBI and State budgets 2001-02

It is evident that the growth of interest liability has not been uniform across the States over the last decade. Major States like Andhra Pradesh, Karnataka, Maharashtra and West Bengal which experienced restrained growth in interest liability during 1990-91 to 1994-95 period experienced accelerated growth during the last four years. In contrast, States like Bihar, Kerala, Punjab and Tamil Nadu, which experienced significantly higher than all-State average growth rates in interest liability, experienced moderated growth rate in such liability during the last four years. It has to be mentioned in this context that a few States like Maharashtra, Gujarat and Karnataka have heavy outstanding guaranteed loans, the interest liability of substantial part of which directly devolve on to the State budgets.

Like interest payment, pension liability is another major committed expenditure of the State governments. Indeed, after salary and interest, pension is the third largest expenditure item in the State budgets. Also, pension outgo was the fastest growing component of the State government expenditure during the last few years. This is mainly on account of the adoption of the Fifth Pay Commission recommendations for the Central government employees by the State governments which involved generous improvement in pension payments to retired employees and their families.

Table II.6 presents the State-wise pension liabilities for the past decade. There was more than six-fold increase in pension liability between 1990-91 and 1999-2000. Indeed, pension liability almost doubled in just two years between 1997-98 and 1999-2000. Of course, this was

the period when pension increase took place as a result of the revisions based on Fifth Pay Commission and the inflated figures included some arrear payments also. That is why in the subsequent years the pension liability came down somewhat.

Table II.6: Pension Liabilities of State Governments

State	1990-91	1994-95	1997-98	1998-99	1999-2000	2000-01(RE)	2001-02(BE)
Andhra Pradesh	330	746	1139	1373	1657	2056	2198
Arunachal Pradesh	4	8	17	32	37	42	N.A
Assam	49	162	248	303	518	463	577
Bihar	187	320	756	1024	1241	1646	1781
Goa	8	15	30	63	71	N.A	N.A
Gujarat	204	381	762	1237	1411	N.A	N.A
Haryana	190	138	258	531	587	542	596
Himachal Pradesh	48	83	165	222	445	N.A	N.A
Jammu & Kashmir	41	55	162	374	413	496	565
Karnataka	277	470	809	972	1540	1569	1811
Kerala	335	565	913	1154	1528	N.A	N.A
Madhya Pradesh	169	385	753	1143	1314	N.A	N.A
Maharashtra	327	489	919	953	1993	N.A	N.A
Manipur	9	26	54	54	60	N.A	N.A
Meghalaya	6	14	22	35	40	55	69
Mizoram	4	8	16	17	25	33	106
Nagaland	7	29	34	40	59	75	N.A
Orissa	75	165	317	475	688	835	999
Punjab	130	218	434	719	1140	1100	1150
Rajasthan	238	300	596	879	1409	1731	1784
Sikkim	1	3	6	15	16	20	21
Tamil Nadu	364	636	1287	1691	2688	2975	N.A
Tripura	18	31	58	69	111	136	N.A
Uttar Pradesh	382	476	1054	1776	2061	2031	2039
West Bengal	189	401	791	1012	1589	1639	1688
Total	3592	6124	11600	16163	22641	17444	15384

Source: RBI and State budgets: 2001-02

Salary revision was not the only cause for the steep increase in pension liability. Several States, over the last few years, have been taking over the responsibility of unfounded pension for the employees in the government-aided institutions. Another noteworthy aspect is that the pension burden in relation to the size of the State budget varies a lot across the States. Thus, for example, while pension accounts for about 10 percent of the revenue expenditure for all States taken together, it is as much as 15 percent in Kerala and Tamil Nadu. While Kerala's case can be explained in terms of early retirement (indeed, Kerala is the only State where retirement is still at age 55 while elsewhere it is 58 or 60) and longer life expectancy, the explanation for the heavy pension burden of Tamil Nadu lies in larger coverage of institutional employees. In any case, this is an area which is ripe for serious studies.

Salary is the single most important component of State government expenditure. Since most of the employee-intensive activities like primary and secondary education, basic health services, law and order and provision of other civic amenities are in the domain of the State governments, it is natural that the State governments have large pay rolls. Since employment opportunities in the private sector have been growing at a much slower rate than the rate of growth of labor force, especially that of the educated labor force, there have been continuous pressure on government employment. As a result, often State governments employ more people than genuinely required. Government employment has two added attractions viz., there is job security and the pay is good compared to the average income in the economy. As a result, there

is continuous pressure on government jobs, especially in States where the private sector is sluggish.

Since the available data on Statewise salaries are a little confusing in view of mixing direct salary and grants-in-aid for salary to aided institutions, we are not in a position to present State-wise salary details. Table II.7 presents the combined salary, pension and interest figures as a percentage of revenue receipts for eight selected States. On the average, salary accounts for roughly 60 percent of the combined figure. The highlights of the table are the following: Firstly, the combined share of the three expenditure items have been remaining more or less steady till 1997-98 for all the given States. However, there was a steep rise in the subsequent two years on account of revision of pay and pensions. In a few cases, this burden exceeded even the revenue receipts. The peak was reached in 1998-99 or 1999-2000 depending on the disbursal of arrears.

**Table II.7: Salary, Pension and Interest
as Percentage of Total Revenue Receipts of Selected States**

Year	Kerala	Rajasthan	West Bengal	Orissa	Andhra Pradesh	Tamil Nadu	Karnataka
1990-91	96.40	48.42	93.90	60.89	60.20	62.51	52.10
1991-92	77.34	52.13	80.01	68.00	59.12	53.09	47.38
1992-93	70.32	54.58	78.12	65.01	58.68	58.51	48.99
1993-94	76.19	55.59	82.72	67.40	57.97	59.77	49.07
1994-95	76.70	57.54	78.65	69.08	66.04	58.92	51.10
1995-96	71.38	56.35	84.24	74.31	64.20	59.54	47.97
1996-97	72.80	68.17	90.43	79.23	64.65	62.55	49.98
1997-98	70.28	70.33	95.12	71.36	59.47	64.70	54.03
1998-99	81.34	91.96	117.82	117.67	67.25	80.82	57.98
1999-2000	104.05	94.77	152.71	97.43	69.16	85.39	63.04
2000-01(RE)	92.57	82.95	107.61	96.13	69.38	78.36	58.75
2001-02(BE)	85.83	87.89	105.46	91.02	69.46	N.A	57.48

Source: State Budgets

The system of cash management of the Indian States is a fairly complex one. Reserve Bank of India (RBI) is the banker to the States. When the State governments exhaust their cash balances, they borrow from RBI up to a limit. This is known as Ways and Means Advances (WMA). The WMA limits are fixed in proportion of the annual reserve expenditure of the States and these are periodically revised upwards. The number of days on which such limits are crossed are characterized as the days in which the State is in overdraft. The seriousness of the current fiscal situation of the States is brought out in Table II.8. If a State is in overdraft continuously for more than 12 working days, the RBI automatically stops payments.

The number of days in which the States have been in overdraft, monthwise, for last financial year, truly indicates the seriousness of the fiscal crisis. It is not just a cash flow problem. Problem is almost perennial for several States. When a State is in overdraft, hardly any payments take place. This implies that State treasuries become virtually non-functional during the days of overdraft. In the case of States like Assam, Kerala, Manipur, Orissa and Uttar Pradesh, such days accounted for more than half the year. Indeed, the data in this table vividly depicts the current fiscal crisis of the States more than any other evidences.

Table II.8: Number of Days per Month States Were in Overdraft During 2000-01

State	Apr-00	May-00	Jun-00	Jul-00	Aug-00	Sep-00	Oct-00	Nov-00	Dec-00	Jan-01	Feb-01	Mar-01	Total 2000-01
Andhra Pradesh	9	-	-	13	12	13	13	14	20	19	17	17	147
Arunachal Pradesh	-	-	-	-	-	-	-	-	-	-	-	-	-
Assam	15	27	22	24	23	18	29	23	26	27	23	26	283
Bihar	7	-	-	-	-	-	14	12	9	15	4	20	81
Goa	4	-	-	1	3	2	-	-	-	-	-	-	10
Gujarat	1	-	-	-	2	7	9	-	12	3	-	-	34
Haryana	17	3	-	1	12	12	13	18	-	-	3	14	93
Himachal Pradesh	13	-	8	13	-	-	-	11	5	13	4	15	82
Jammu & Kashmir	-	-	-	-	-	-	-	-	-	-	-	-	-
Karnataka	-	-	-	-	-	-	-	-	-	-	-	-	-
Kerala	11	14	12	14	20	21	18	19	15	13	21	26	204
Madhya Pradesh	-	-	-	2	-	-	7	6	-	16	-	16	47
Maharashtra	8	-	4	-	-	-	-	-	-	2	8	15	37
Manipur	2	28	26	31	15	8	24	22	28	27	28	24	263
Meghalaya	-	-	-	-	-	-	-	-	-	-	-	-	-
Mizoram	10	17	-	-	-	-	-	-	-	-	-	5	32
Nagaland	11	13	10	11	1	-	-	-	-	-	-	5	51
Orissa	1	6	11	14	13	10	26	24	28	25	14	22	194
Punjab	10	-	-	8	-	25	2	1	16	20	-	23	105
Rajasthan	12	-	-	22	11	5	16	11	20	16	5	10	128
Sikkim	-	-	-	-	-	-	-	-	-	-	-	-	-
Tamil Nadu	13	-	-	-	2	4	5	1	14	20	12	5	76
Tripura	-	-	-	-	-	-	-	-	-	-	-	-	-
Uttar Pradesh	15	23	22	19	22	20	21	5	13	23	7	19	209
West Bengal	8	11	-	18	-	5	6	1	21	27	25	12	134

Source: Compiled from Monthly Summary of the Department of Expenditure, Ministry of Finance, Government of India. The original data come from RBI.

Table II.9 gives the comparable statistics of Uttar Pradesh, Karnataka and Jharkhand along with that of all India. While data relating to Uttar Pradesh, Karnataka and all-India are from various original sources, only few data relating to Jharkhand were available in such original sources as this is a new State which came into existence just a year ago (on November 14, 2000 to be precise). Other figures for Jharkhand have been estimated using the data available for Bihar with appropriate assumptions.

Table II.9: Comparative Statistics of India, Uttar Pradesh, Karnataka and Jharkhand

Particulars	India	Uttar Pradesh	Karnataka	Jharkhand
Population (Millions)	1027.0	166.1	52.7	26.9
Share of population (percentage)	100	16.2	5.1	2.6
Rank in terms of population	-	1	9	13
Annual growth rate of population (percentage)	1.9	2.3	1.6	2.1
Population density (per sq. km)	324	689	275	338
Density rank	-	9	20	16
Sex ratio (female per 1000 male)	933	898	964	941
Literacy rate (persons) (percentage)	65.4	57.4	67.0	54.1
Literacy rate male (percentage)	75.9	70.2	76.3	67.9
Literacy rate female (percentage)	54.2	43.0	57.5	39.4
Ranking of States by literacy rate	-	31	22.0	33
Crude birth rate	26.5	32.4	22.0	31.1
Crude death rate	8.8	11.0	7.4	9.5
Infant mortality rate	73.5	92.9	55.7	66.5
Maternal mortality	408	707	195	452
Number of districts	593	70	27	18
Per capita income (in Rs)	14750	9261	15889	8292
Annual growth of per capita income in real terms	4.5	2.0	5.8	3.00
State's own tax revenue as percentage of GSDP	-	4.6	7.9	6.5
GFD as percentage of GSDP	-	6.8	3.5	1.2
Plan expenditure as percentage of GSDP	-	3.9	4.8	2.2
Capital outlay as percentage of GSDP	-	1.2	1.7	0.8
Revenue deficit as percentage of GFD	-	74.8	39.1	Nil
State's own tax revenue as percentage of GFD	-	68.0	223.1	250.0
Female life expectancy	63.4	61.1	65.4	62.1

Note: GSDP: Gross State Domestic Product

GFD: Gross Fiscal Deficit

ANNEX III

Contributors to Fiscal Deficit

A. Pension

In India, government-sponsored retirement income support programs take three general forms: insurance programs; voluntary savings that are encouraged through favorable tax treatment; and direct government transfers to the elderly poor. Table III.1 below summarizes the major schemes, statutory coverage, financing sources and eligibility conditions. Since the principle concern of this assessment is the fiscal condition of the states, this report focuses on the fiscal pressures resulting from state sponsored pension schemes. As Table III.1 shows, Civil Service Pensions and State Level Social Assistance are financed by state budgets.

State spending for civil service pensions has risen dramatically in the last few years. In some states the ratio of pension expenditures to gross state domestic product (GDSP) has more than tripled. In the largest state, Uttar Pradesh, for example, this ratio rose from 0.4 to 1.2 percent between 1990 and 2000. In Rajasthan, the ratio rose from 0.8 to 2.3 percent over the same period.

There are three trends that contribute to the growth of state expenditure on pension schemes during this period: the growth in the number of pensioners (civil and family pensioners); indexation of civil pensions for inflation (i.e., Dearness Allowances); and upward revision of pensions on account of states adopting the recommendations of the Fifth Pay Commission.

The Government of Tamil Nadu has issued an analysis of the relative contribution of these three factors to the growth in aggregate pension expenditures between 1987-88 and 1999-00. During this period, aggregate pension expenditure in the State of Tamil Nadu increased from Rs. 198 crores to 1,852 crores or, in other words, an annual compound growth rate of approximately 25 percent. Based on a simple decomposition of the sources of growth in aggregate pension expenditures in Tamil Nadu, they reach the following conclusions:

1. The increase in the number of pensioners accounts for about 25 to 30 percent of the incremental change in the aggregate pension expenditure.
2. The impact of increase in basic pension, including Dearness Allowances (?), account for the remaining two-thirds of the incremental change in aggregate pension expenditure.
3. The recent revision in pensions on account of Pay Commission recommendations accounts for an additional expenditure of Rs. 415 crores per annum.

Table III.1: Government-Sponsored Schemes for Retirement Income Security in India

Program	Legal Coverage	Effective Coverage	Financing
Compulsory Schemes			
Employees' Provident Fund	Employees in firms with more than 20 employees	About 5.8 percent of the labor force	Employer and employee contributions
Employees' Pension Fund	Same as above	About 5.4 percent of the labor force	Employer, government contributions
Civil Service Pension Scheme	Civil servants at state and federal level	About 3.5 percent of the labor force	State or central government budgets
Government Provident Fund	Civil Servants at state and federal level	Most civil servants	Employee contributions
Special Provident Fund	Certain occupations and employees in Jammu and Kashmir	About 0.5 percent of the labor force	Employer and employee contributions
Voluntary, Tax Preferred Schemes			
Public Provident Fund	All individuals	About 0.8 percent of the labor force	Contributions
Superannuation Plans	All employees	About 0.2 percent of the labor force	Contributions
Personal Pensions	All individuals	About 0.2 percent of the labor force	Purchases of annuity-like products
Social Assistance			
State Level Social Assistance	Varies by state	Varies by state	State budgets
National Old Age Pension Scheme	Destitute persons over age 65	About 15-20 percent of population over age 65	Central budgets

Box III.1: A Brief Description of State Civil Service Pension Schemes

All state civil servants, including employees of public sector enterprises, are covered by a non-contributory; defined benefit scheme that uses a final salary-based formula in calculating a pension. The defined benefit formula is calculated as follows: an accrual rate of slightly more than 1.5 percent per year of service is multiplied by the wage of the civil servant during his final ten months before retirement. This applies for the case of a full pension, which requires a minimum of 20 years of service. Partial pensions can be paid upon completion of ten years of service and the maximum number of years taken into account is 33 years. Finally, post-retirement adjustments are automatically made for price changes based on consumer price indices and increased further on a periodic basis after the recommendations of each decennial Pay Commission.

The compensation system of civil servants, including the determination of pension levels, is somewhat opaque. A schedule of civil servants salary ranges by grade does exist, but a significant part of the wage bill is paid in the form of dearness allowance based on a formula intended to compensate workers for price changes every six months. In addition, there are other allowances (e.g., housing and travel) that are based on other criteria. The importance of these allowances in the compensation package depends on how recently the decennial Pay Commission has revised the salary structure. From the perspective of pension calculations, this means that the defined benefit formula applies to only a fraction of the actual remuneration of a typical civil servant.

The process of determining the initial pension level is further complicated by the fact that part of the pension can be “commuted,” in other words, taken as a lump sum upon retirement. The Fifth Pay Commission increased the portion that could be commuted from 33 to 40 percent. Most pensioners appear to take full advantage of the commutation option. The normal retirement age was 55 until 1962 when the Second Pay Commission raised it to 58. The third and fourth Pay Commissions recommended maintaining this age limit. After 35 years, it was finally increased to 60 in 1998.

While increases in aggregate pension expenditures due to the growth in the number of pensioners reflects hiring decisions taken many years ago, growth due to Dearness Allowances and adoption of the Pay Commission recommendations are more immediate and elective on the part of the state. Apparently states adopted policies, such as applying the salary revisions recommended by the Fifth Pay Commission to state employees, without analyzing the budget implications of these decisions. Tellingly in this regard, there is a dearth of analysis of the budget impact of state pension policies. In fact, many states lack the necessary data on current state employees and pensioners to undertake meaningful studies of the budget implications of their future pension liabilities. More specifically, the States of Jharkand, Karnataka and Uttar Pradesh lack essential information on the determinants of future pension liabilities, such as the age, marital status, number and age of dependent children, pay grade and time in station of current state employees.

The absence of such data also makes the state pension schemes vulnerable to fraudulent claims. For example, officials in Uttar Pradesh do not have a system in place to prevent individuals from making double or triple claims or fraudulently claiming pension payments on behalf of deceased persons. While officials in Jharkand are confident that their system is not subject to widespread abuse of this type, they are relying on informal community policing to prevent such abuses. These officials acknowledge that community policing will be less effective if, as expected, urban population increases in the state.

Outlays on pensions are likely to continue to grow rapidly at the state level because employment has more than doubled over the previous 30 years, leveling off only recently. Future growth in the pension bill will reflect this “bulge” of employment. Preliminary evidence from individual states suggests that the bulge will begin to decline in the next five years. Unfortunately, as previously noted, available information is inadequate and reliable projections are not available. Furthermore, these calculations do not account for the pension liabilities of public sector enterprises. Given the low rate of cost recovery by such enterprises, this could be a source of further pressure on state budgets.

In India, civil servants do not explicitly contribute to the pension scheme and no fund is accumulated. In other words, the system operates on a pay-as-you-go basis. But, transforming state civil service pension schemes into contributory plans may not relieve the pressure on state finances from civil service pension expenditure. In fact, unless the reforms are carefully designed and their budget implications fully examined, pension reform could put added pressure on state finances.

There are three ways that state governments could transform the current pay-as-you-go scheme into a contributory one. First, they could create a separate fund for employer contributions equivalent to pension expenditures for each year. This accounting device would make it appear as if the scheme is balanced, however, employer contributions would appear as an outlay in the general budget. Once the special pension fund and the general budget are consolidated, the revenue would net to zero. Unless the government contribution is financed by a tax increase or a reduction in other expenditures, the state deficit would be unaffected.

Second, a state could require current state employees to make mandatory contributions to the pension fund equivalent to pension expenditures for each year. Again, to the extent that states increase civil service wages to finance employee contributions to the fund, the consolidated budget deficit will be unaffected. In other words, for purposes of the consolidated deficit it does not matter if there is a contribution or not. The only difference between a contributory scheme and a non-contributory scheme arises when the wage does not already reflect an implicit contribution. The question that then arises is whether states have the political will to resist demands by public employees and their union representatives to finance the contribution with a tax increase. Governments in India do not have a very good record in this regard.

Finally, a state may require current employees to contribute to a fund that is invested in public or private debt or securities. Such pension schemes offer two advantages over pay-as-you-go schemes. Depending on the average rate of return on such investments, this type of contributory scheme may offer higher benefits to retirees than the current pay-as-you-go scheme.

In addition, an invested fund may increase net private savings, which would lead to an increase in investment and, thereby, foster economic growth. In the short to medium term, however, an invested fund will not relieve the pressure on state budgets from financing current pensions liabilities.

There may be many sound reasons for states to convert the current pay-as-you-go civil service pension scheme into a contributory scheme. Unless it is financed with a tax increase or expenditure reduction, however, pension reform will not relieve pressure on state finances from this source. The purpose of this brief critique of potential pension reforms is not meant to argue for or against reform, but rather to demonstrate that successful reform will require careful analysis of the state budget implications.

As previously noted, forecasting future civil service pension liabilities requires detailed employee profiles, including their age, pay grade and length of service. To forecast liabilities arising from family benefits requires additional information on the age of the spouse as well as the number and age of dependent children of each employee. With this information in hand and by making assumptions on important parameters, such as the rate of inflation, rates of disability and mortality, and take-up rate of lump-sum distributions, it would be a simple matter to simulate the budget implications of future pension liabilities under a variety of reform scenarios.

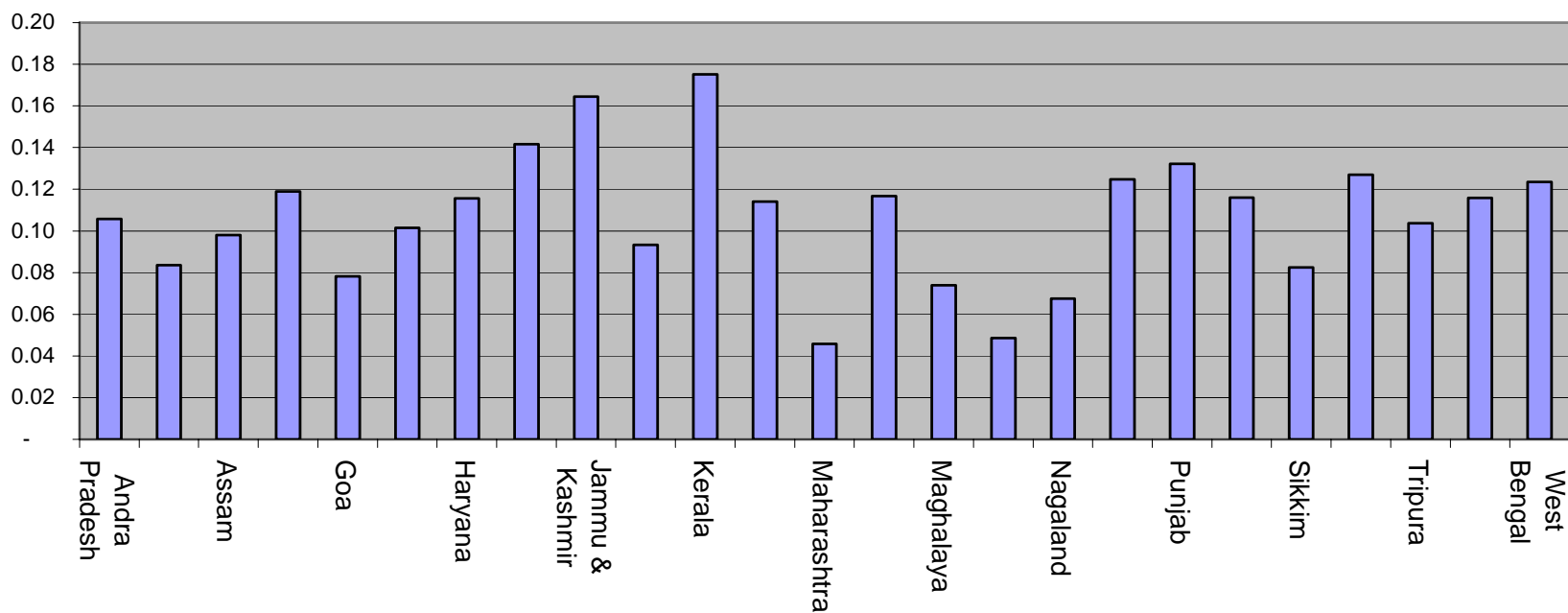
While the states that we visited have basic information on their employees, specifically name and pay grade, they lack the necessary detail on the age, length of service, number and age of dependents of their employees to undertake meaningful simulations of the budget implications of alternative pension reforms. USAID may like to consider helping one or two states to develop a human resources database with the requisite employee profiles to undertake such simulations. In addition, USAID could provide technical assistance in the development of a pension simulation model and training in the maintenance, operation and improvement of such a model. The pension model could be developed, maintained and operated within the government, say the Ministry of Finance, or in a local university or think-tank. In addition, the human resources database could also be used for other important government purposes, including forecasting the wage bill, which is another source of budget pressure.

Table III.2: Pension Liabilities of State Governments

(Rs. Crores)

	90-91	91-92	92-93	93-94	94-95	95-96	96-97	97-98	98-99	99-00	00-01	01-02	Percent change
Andra Pradesh	330	411	444	510	746	893	1,004	1,139	1,373	1,657	2,056	2,198	502%
Arunachal Pradesh	4	4	6	7	8	10	12	17	32	37	42	-	925%
Assam	49	82	34	134	162	180	214	248	303	518	463	577	1057%
Bihar	187	224	243	260	320	556	702	756	1,024	1,241	1,646	1,781	664%
Goa	8	9	11	13	15	20	24	30	63	71	-	-	888%
Gujarat	204	233	261	298	381	458	609	762	1,237	1,411	-	-	692%
Haryana	190	90	107	120	138	166	244	258	531	587	542	596	309%
Himachal Pradesh	48	52	62	77	83	103	127	165	222	445	-	-	927%
Jammu & Kashmir	41	44	47	50	55	68	105	162	374	413	496	565	1007%
Karnataka	277	297	349	410	470	559	716	809	972	1,540	1,569	1,811	556%
Kerala	335	339	372	465	565	717	754	913	1,154	1,538	-	-	459%
Madhya Pradesh	169	217	255	330	385	528	682	753	1,143	1,314	-	-	778%
Maharashtra	327	322	368	433	489	604	790	919	953	1,993	-	-	609%
Manipur	9	25	18	21	26	32	47	54	54	60	-	-	667%
Maghalaya	6	7	9	12	14	16	21	22	35	40	55	69	667%
Mizoram	4	4	5	7	8	10	15	16	17	25	33	106	625%
Nagaland	7	10	9	30	29	30	32	34	40	59	75	-	843%
Orissa	75	95	122	146	165	194	253	317	475	688	835	999	917%
Punjab	130	143	157	191	218	280	348	434	719	1,140	1,100	1,150	877%
Rajasthan	238	180	206	260	300	374	490	596	879	1,409	1,731	1,784	592%
Sikkim	1	2	2	3	3	4	5	6	15	16	20	21	1600%
Tamil Nadu	364	401	472	540	636	787	1,070	1,287	1,691	2,688	2,975	-	738%
Tripura	18	20	22	29	31	36	45	58	69	111	136	-	617%
Uttar Pradesh	382	293	474	426	476	723	894	1,054	1,776	2,061	2,031	2,039	540%
West Bengal	189	218	253	338	401	466	625	791	1,012	1,589	1,639	1,688	841%
Total	3,592	3,722	4,308	5,110	6,124	7,814	9,828	11,600	16,163	22,651	17,444	15,384	631%

Chart III.1
Ratio of Pension Liabilities to Total Revenue
(1998-1999)



B. Public Sector Enterprise Reform/Infrastructure

According to World Bank (WB) estimates for 1999-00, there are 1,000 public sector enterprises (PSE) at the state level. Though a number of PSEs have been privatized, the progress has been slow. The WB estimates that the lack of PSE reform costs the Indian economy 2 percent growth in Gross Domestic Product (GDP) per annum.

Table III.3 below provides a brief overview of the three states. Karnataka and Uttar Pradesh have 78 and 47 PSEs, respectively. As a newly formed state, Jharkand does not have any PSEs, rather the enterprises that could be considered PSEs fall under various state ministry categories.

Table III.3: Overview of Public Sector Enterprises

State	Number of PSE	Number of Employees	Aggregate Net Loss	Privatization Strategy
Jharkand	na	na	na	Concept under discussion
Karnataka	78	162,000	Rs. 110 crores	Strategy Approved
Uttar Pradesh	45	148,500	Rs. 45 crores	Strategy Approved

Source: GoUP, GoK, World Bank 2001.

The Largest PSE: The Power Sector

The power sector is the largest public sector enterprise in terms of number of employees, revenue generation and state subsidy. Many state officials recognize that power sector reform is an important element of any strategy to restore stability to state finances. The following section provides a brief overview of the power sector in India, with a focus on Jharkand (Bihar), Karnataka and Uttar Pradesh (UP).

Chart III.2 below illustrates the energy consumption per capita of these three states relative to the India-wide average. While Karnataka ranks significantly higher than the India average, Bihar and UP rank lower than the India average per capita consumption of electricity.¹ In 1999, per capita consumption of electricity in India was 360 Kwh. In Bihar, Karnataka and UP, per capital energy consumption was 152 Kwh, 350 Kwh and 195 Kwh, respectively.

¹ In the absence of any effective power sector data for the State of Jharkand, the time series attributed to the State of Bihar was used. Note that the newly formed State of Jharkand is the result of the bifurcation of Bihar.

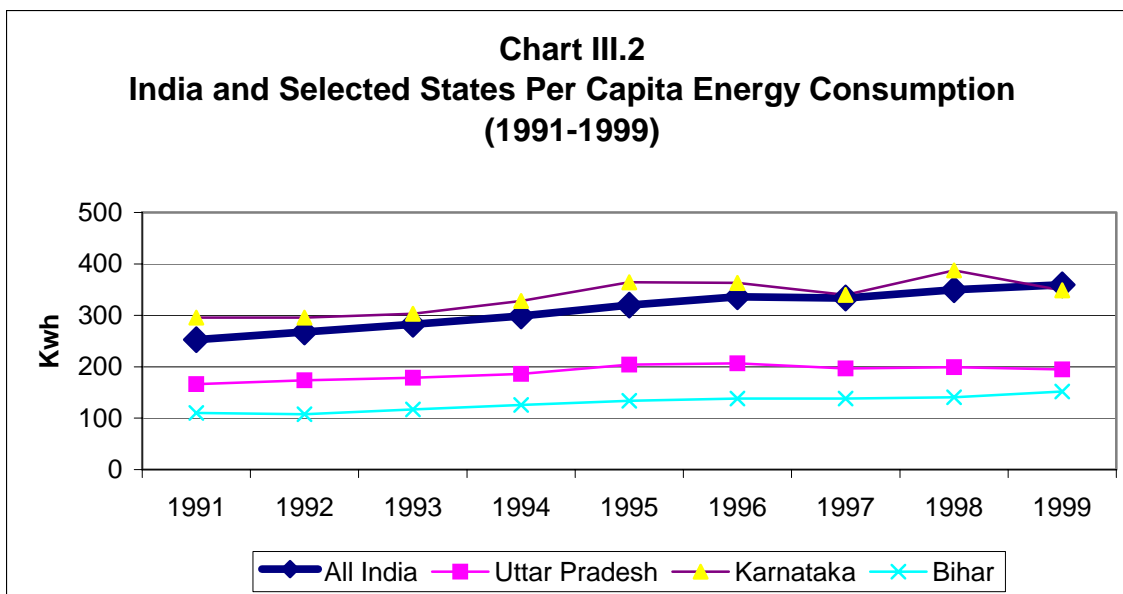


Chart III.3 below portrays the cost structures of the power sector for these three states relative to the Indian-wide average. The cost structure of the power sector has been growing rapidly. The Bihar State Electricity Board's (SEB) cost structure is substantially greater than the national average and that of Karnataka and UP. A brief review of these three states shows that Karnataka has accelerated its privatization and electric power modernization program, while Bihar and UP lag substantially behind the Karnataka's reform pace.

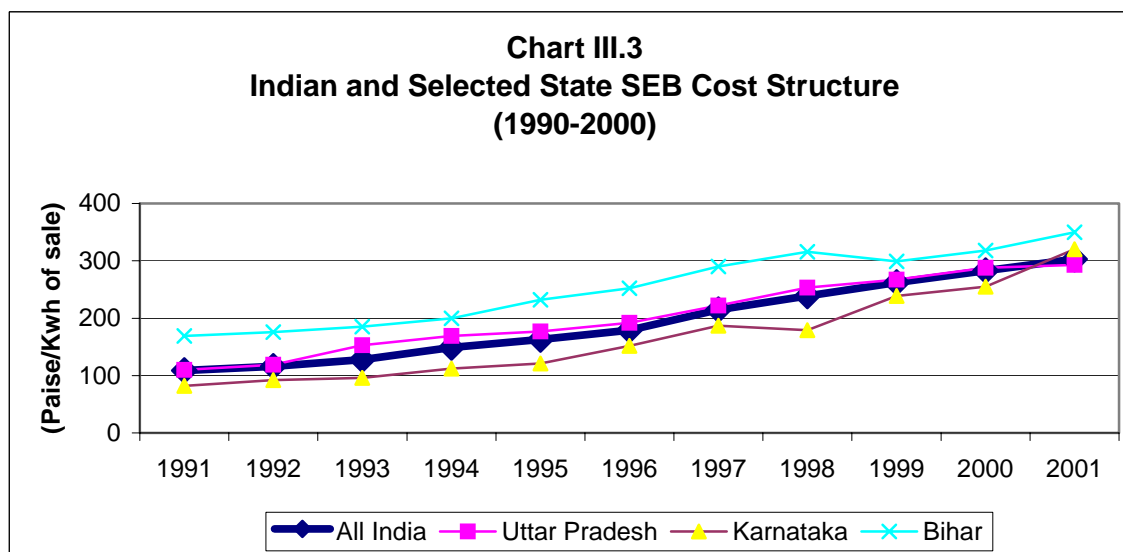
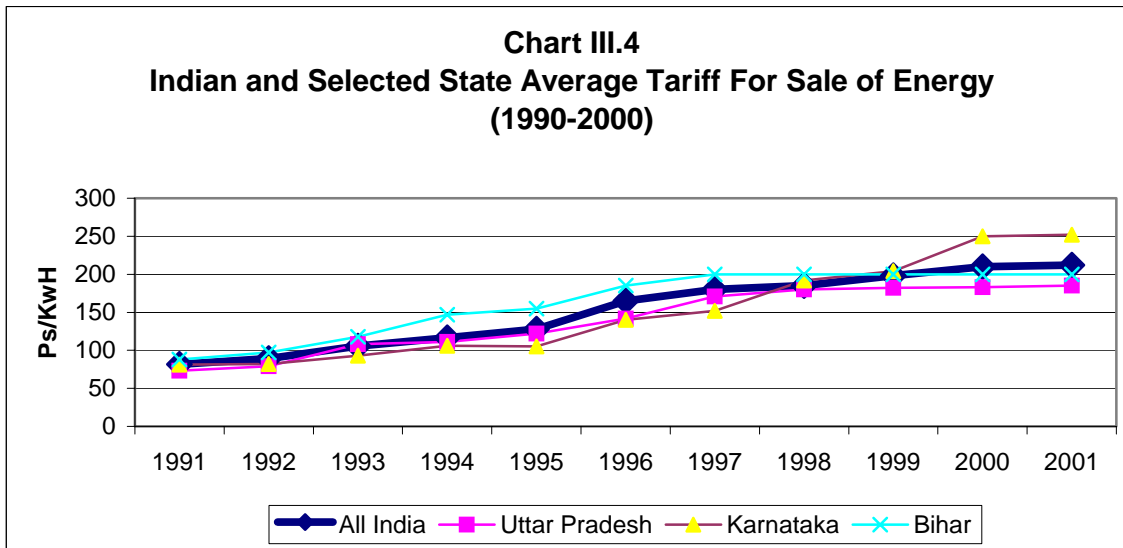


Chart III.4 illustrates the India-wide average tariff structure as well as the tariff structure of these three states. Bihar's (Jharkand) power tariff has flattened out over the past three years at 200 paise per Kwh. Karnataka, which is a reform state, has substantially increased its power tariff over the past two years; whereas, UP, which is a slow reform state, has only recently increased power tariffs.



By mapping the average tariff against the various State's cost structures, it should not be surprising that the average revenue realized by power utilities per unit of power sold, has been substantially less than the unit cost. The utilities have financed the excess of expenditure over income through a combination of subventions including: subsidies from the various state governments; issuing bonds and debentures (largely with government guarantees); and withholding payments to various suppliers, particularly the national railroad and coal companies. Over the past few years, withholding payments to various suppliers has been the dominant, and growing, means of financing the power sector. The continuing deficits have forced the various SEBs to reduce their expenditure on the maintenance of assets, and prevented additional expenditure on capital improvements.

A quick review of the outstanding liabilities of the SEBs shows that Bihar and UP rank number one and two with respect to outstanding debt of the power sector. Bihar's estimated outstanding liabilities stand at 5,475 crores. UP's estimated outstanding state power liabilities approach 4,257 crores. More pointedly stated, Bihar and UP account for over one-third of the total debt related to electric power for all the states of India. Clearly, reforming the state electric power sector should translate into an immediate and perhaps sustainable positive impact on state finances.

A Brief Snapshot by State

The following section presents a brief overview of the policies that UP, Karnataka and Jharkand currently are pursuing with respect to improving public enterprise reform and infrastructure development.²

² According to the Urban Policy and Action Plan for Kerala, urban areas (including Ranchi, Bangalore, Luchnow etc.) account for 30 percent of Indian population and 60 percent of the Gross Domestic Product. Urban areas however receive only 15 percent of the plan allocation. This puts severe stress on the development of urban municipal services.

Uttar Pradesh

The public enterprise sector in Uttar Pradesh (including electric power) consists of 45 enterprises employing more than 223,000 people. More than two-thirds of public sector enterprise employees are employed in the three largest PSEs (power, water, transport). The State Power Corporation and the State Road Corporation, with more than 88,000 and 50,000 persons employed, respectively, are the largest PSEs. The substantial level of public sector enterprise employment is one of the contributing factors behind Uttar Pradesh's poor economic performance.

In 2000, UP public sector enterprises have a combined negative net worth totaling an estimated Rs10.2 billion. According to a recent World Bank analysis, several enterprises continue in operation for the sole purpose of providing employment, or on the basis of work for UP state Government Departments on an exclusive basis (?). No resources are being spent on additional maintenance or capital investments for these enterprises. This has led to a general deterioration of equipment and technological obsolescence of many PSEs.

The main areas of State fiscal drain resulting from Uttar Pradesh PSEs are: 1) direct subsidies (as in the case of enterprises that are closed and have no operations, yet continue to employ workers); 2) costs associated with contracts being awarded to PSEs on a non-competitive (exclusive) basis; and, 3) credits to PSEs that are insolvent and have no ability to repay these credits.

GoUP

The primary objective of the GoUP's PSE reform program, as elaborated in its Public Enterprise Reform and Privatization policy paper, is to increase efficiency in the use of public resources and reduce the managerial and financial burden on the government through divestment, privatization or closure of enterprises that compete with the private sector or are fundamentally commercial in nature.

UP's public enterprise reform and privatization policy started in FY2000 and is expected to continue over the next 5 years. GoUP's privatization and reform policies rely on a divestment commission (DC) that has been established to prepare recommendations on the method of divestment or closure. In addition, a working committee has been created to implement the Cabinet's decisions on divestment and closure of enterprises. The PSE policy paper also provides guidelines for an open and transparent divestiture/closure of PSEs including detailed procedures for voluntary retirement programs and environmental issues.

As part of Phase I of the enterprise reform process, the GoUP identified a list of six public enterprises (involving 20 production units), accounting for about 19,000 employees, and shut them down. Apparently, the primary criteria for including these six enterprises in the first phase of the reform program are that they either were already shutdown or were about to shut down. The UP government has also imposed a ban on new credits to PSEs from the budget with

the exception being power and Voluntary Retirement Schemes (VRS) payments. In addition, in each of the following three years, about eight PSEs (per annum) will be divested or closed.

Preliminary estimates of the costs and savings by World Bank and GoUP officials indicate that the closure of six state enterprises in the first half of 2001 cost the GoUP about Rs 2.2 billion in voluntary retirement scheme (VRS) payments. The net direct savings from not having to fund future losses for these Phase I firms is estimated at Rs 0.6 billion per annum.

UP – The Power Sector

In March 1998, GoUP Finance Department issued a *White Paper* highlighting the gloomy state of economic affairs (fiscal stress, high levels of state indebtedness, and deteriorating economic conditions). The *White Paper* led to the adoption of power sector reforms. The State's Cabinet enacted a new electric power policy in 1999.

The power policy reform led to the unbundling of the UP State Electricity Board (SEB) into three separate entities: UP Thermal Generation Corporation; UP Hydro Generation; and UP Power Corporation Ltd (for transmission and distribution). With respect to the power sector, GoUP has passed numerous reform bills, and a State Energy Regulator Commission (SERC) was constituted. In July 2000 the SERC issued a tariff increase. Clearly, GoUP officials actively recognize that power sector reform is a sine qua non of restoring fiscal stability to the State.

The World Bank has committed a loan of U.S.\$150 for reform and restructuring of the state power sector. A preliminary review of the status of this loan and the restructuring program by WB officials indicate that there has been some headway in energy company corporate restructuring and financial management systems improvements. The GoUP has put out for tender, on three separate occasions, the distribution company in Kanpur. Notwithstanding, there were no private sector bidders for the distribution company. The relatively high level of indebtedness and liabilities accumulated by the power sector due to years of financial mismanagement ensure that there will most likely be substantial costs incurred in privatizing the enterprises.

Subsidies and Cost Recovery

GoUP cost recovery levels for social and economic services including power, water, and sanitation are dismally low. There is additional scope for increasing user charges in various services provided by GoUP. As shown in Table III.4, below, the aggregate recovery level of social and economic services is estimated at 4 percent. Total aggregate subsidies amount to Rs. 17,800 crores, or 10 percent of GSDP (and, 66 percent of revenue expenditure). The highest share is in the education sector among social services. In economic services, agriculture, irrigation and flood control, energy and transport are the main services responsible for the bulk of unrecovered costs.

Table III.4: Estimates of Unrecovered Costs 1998-1999

	Cost	Unrecovered Cost	Recovery Rate	Unrecovered Revenue Expenditure	Cost as Percentage of GSDP	Cost as a percentage of fiscal deficit
	-----	(Rs crore)-----	-----	-----	(percentage)-----	-----
Social Services	8,598	8,413	2.15	32.3	4.9	50.6
Economic Services	9,229	8,700	5.73	33.4	5.1	52.3
Total	17,827	17,113	4.00	65.6	9.9	102.9

Source: National Institute of Public Finance and Policy. Uttar Pradesh: Study of State Finances, p. 21.

A breakdown of the total estimated subsidies indicate that nearly 49 percent of GoUP subsidies are in social services and 51 percent are in economic services. The recovery rate in social services is 2.15 percent, whereas in economic services the recovery rate was 5.73 percent. A cursory review of the relative share of services on the economic side indicates that agriculture, irrigation and transport services account for 16, 15 and 6 percent of GoUP subsidies, respectively.

On the social side, the highest claims on subsidies stem from the education sector (60 percent). Secondary education, university and higher and technical education offer some hope for increasing cost recoveries. These account for 13 percent of the total social sector subsidies. Medical and public health account for about 5 percent of the subsidies of which 4 percent are for medical services. Nearly 18 percent of the subsidies on the social side and nearly 40 percent of the subsidies on the economic side constitute areas where there is significant scope for increasing cost recovery rates.³

Karnataka – PSE Overview

According to World Bank estimates (June 2001), Karnataka has 78 public sector enterprises with a total of about 162,000 employees. Five PSEs are utilities (power and transport). Of the remaining PSEs, 32 are manufacturing (10 non-operational) and 23 are service and marketing enterprises. Excluding the public utilities (power, water) the sector has a net loss of Rs. 110 crores.⁴

The reduction of the fiscal burden on account of PSEs is expected to assist the state in improving its fiscal position. As a result, the Government of Karnataka recently approved a policy paper on “State Public Sector Reforms and Privatization.” The basic principal of Karnataka policy paper is that the state is expected to withdraw from all commercial activities through privatization or closure.

Phase I of the program is expected to undertake the privatization of ten enterprises by March 2002. With the completion of Phase I, it is expected that some of Karnataka’s other

³ The GoUP health sector is already taking steps toward greater cost recovery. The sector has increased user charges by 50 percent at various facilities. People living below the poverty line are, however, to be exempted from paying enhanced user charges.

⁴ World Bank. 2001. *India: Karnataka Restructuring Project*. The World Bank. PREM – South Asia Region. Washington, D.C. Page 3.

major loss-making public sector enterprises be privatized (or closed). GoK is planning to privatize 10 public sector enterprises per annum. It is expected that only the enterprises that provide predominately promotional and social services will remain in government hands beyond 2005.

Karnataka Power Sector Reforms

As in UP, power sector reforms are critical to Karnataka's growth and to the success of State fiscal reform. Serious power shortages, unreliability, and losses and thefts (estimated at 40 percent) have made the power sector the leading infrastructure constraint for the state. Increasingly, high-tension industrial consumers have started to leave the utility's grid. More than 80 percent of all industries located in the state have back-up power systems.

According to the most recent GoK budget estimates, Karnataka's power sector deficit is increasing rapidly and poses the most serious threat to fiscal sustainability. The Power sector deficit has doubled from 1 percent of GSDP in 1990, to more than 2.1 percent of GSDP in 2001. Total losses in the power sector are principally due to high theft and losses and a heavy subsidy to agriculture estimated at Rs 18 billion.⁵ In addition, increased reliance on thermal generation, industrial customer withdrawal from the power grid, higher fuel costs, and a tariff that has remained unchanged (1998 to January 2001) have combined to dramatically increase the state power sector's operating deficit.

As a result, reforming the power sector has become an important part of GoK's state fiscal reform efforts. The primary objective of the power sector reforms is for the GoK to withdraw from the power sector as an operator and lender of last resort. The first phase of the reforms begun in 1999 is complete. These reforms include: 1) Karnataka Electricity Reform Act (1999); 2) power sector reform policy (2000)(unbundling of generation, transmission and distribution companies); 3) establishing the Karnataka Electricity Regulatory Commission (KERC) (1998) which regulates the power sector and establishes tariffs; and, 4) approving a Financial Restructuring Plan (FRP) for the power sector.

The Financial Restructuring Plan (FRP) for the power sector has important implications for GoK's objective of restoring fiscal health and stability to state finances. The FRP sets out a path for reducing the sector's deficit from 2.1 percent of GSDP in 2001 to 0.8 percent of GSDP in 2005. The reduction of the state power sector's deficit by 1.3 percent of GSDP over the next four years is expected to greatly assist in compressing the state's fiscal deficit from 7.2 percent of GSDP in 2001 to 3 percent of GSDP in 2005.

The measures to be undertaken in the FRP include: 1) A reduction in losses and theft from 40 percent to 28 percent over the next 5 years; 2) an improvement in collection efficiency so that accounts receivables fall from 95 days to 85 days; 3) universal metering; 4) and annual tariff increases from the KEREC such that the average tariff approaches cost recovery.

⁵ State Finance officials estimated that over the 1998/99 period the GoK paid Rs 915 crores to the Karnataka Electricity Board by way of explicit subsidy alone.

Karnataka – Other Infrastructure

The following section represents a brief overview of GoK's road and water supply/sanitation infrastructure.

Road / Transport Sector

Karnataka state financial records indicate that over 1998/1999 periods losses from the Karnataka State Road Transport Corporation amounted to Rs 54.6 crores. This loss was in addition to a state government subsidy of Rs 41.2 crores. Clearly, the state's road and power sectors continue to be a major drain on the state's finances.

Inadequate road infrastructure and deterioration have adversely affected economic growth beyond the Greater Bangalore area. The GoK intends to increase its spending on roads and bridges with increased reliance on the private sector for construction, maintenance and financing.

In March 2001, the GoK approved an institutional strengthening action plan. The core premise underlying this institutional strengthening action plan is to transform the Karnataka Public Works Department from a traditional public-sector roads department to a performance-based, demand driven road agency. Some of the changes outlined in this action plan include: 1) separation of the roads and buildings functions into two separate departments (Highways and Buildings); 2) improvements to financial management, computer, and audit functions; and, 3) expanded private sector participation in the road sector by outsourcing of public works and increased private sector financing.

In the case of the GoK's transport sector, significant reductions in subsidies are envisaged over the medium term. These improvements in transport cost recovery will be achieved by rationalizing transport pricing policy and improving productivity. The Medium Term Fiscal Plan for Karnataka (2000-01 to 2004-05) calls for a stepped up pricing policy, improving transport cost recovery from concessional pass holders from 6 percent to 15 percent by 2005. The GoK has already permitted the Road Transport Corporation(s) to modify tariffs automatically based on the change in the costs of inputs (fuel, salary, etc).

Water Supply / Sanitation

The GoK is rapidly moving forward in improving its water supply and sanitation facilities. At present, only 72 percent of households have access to safe drinking water. Only 24 percent have access to toilet facilities. The GoK has recognized that these low levels of local community access to water and sanitation represent a significant health problem. Both urban and rural water supply suffers from chronic inefficiencies, unreliable service quality, limited coverage and low-cost recovery.

The GoK is attempting to implement some private sector solutions to water and sanitation. In the urban areas, the GoK has produced a policy paper on Urban Water and Sanitation that will serve as a basis for urban water reforms – including the introduction of private sector water management.

In the rural sector, the GoK is enacting community-based policies as outlined in the GoKs Rural Water Supply and Sanitation Policy (2000-2005). Recent rural water policy reforms make the local community water district responsible for water delivery and for improving cost recovery. Each local community's Water Supply and Sanitation Committee is expected to pay 100 percent of rural water/sanitation operation and maintenance expenditures and 15 percent of capital costs.

Jharkand

Jharkand is a newly created State with no public sector enterprises – except for electric power. In effect, all of industries, corporate firms, or PSEs that one would associate with in UP or Karnataka, are in essence extensions of ministerial departments. With respect to infrastructure development, several ministerial departments oversee infrastructure development including, but not limited to rural and municipal development.

The Deteriorating State of Infrastructure

According to the Development Commissioner, the State's infrastructure is so poor that 60 percent of the villages are not covered by water/sewerage/roads. With respect to electrification of the 32,000 villages that exist in the State, 26,000 do not receive electricity at all. Even for the estimated 5,000 to 6,000 villages that do receive electricity, it is often sporadic.

Irrigation, or lack of irrigation, is the pre-eminent infrastructure related issue. There has been little or no capital investment in irrigation systems (or rehabilitation) over the past few years. The Development Commissioner repeatedly stated that they need additional capacity to design irrigation systems. In addition, the Commissioner stated that they might require additional capacity to understand how to hire, and evaluate consultant work product.

Jharkand Electric Power

Like many states in India, Jharkhand has been experiencing substantial shortages of energy in recent years. In the combined Bihar (Jharkhand) power statistics, Jharkhand ranks as the fifth, or sixth, most power deficit state in the country. There appears to have been little additional investment in this sector.

The Jharkhand State Electricity Board was established on January 10, 2001. The State government has created two state companies: 1) Tenughat Vidyut Nigam Ltd. (TVNL) for implementing the Tenughat Thermal Power Station (capacity 1550 MW); and, 2) The State

Hydroelectric Power Corporation (BSHPC) for promoting hydropower in the State. The State electricity generating capacity is currently around 1300 MW.

The per capita consumption of electricity in Jharkhand is one of the lowest in India, estimated at 158 Kwh. In a GOI survey, the peak electricity demand for Jharkhand is estimated at 600 MW with energy requirements estimated at 4424 million units.

Added to the inadequate levels of investment, the efficiency of generation and distribution has also been limited. According to State Power officials, the plant load factor is currently estimated at 15 percent. There is an increasing desire to push the load factor to 60 percent. State officials estimate that they are currently losing close to 45 percent of their power due to transmission and distribution losses.

State power officials are clearly interested in devising strategies and methods for reducing power losses to 15 percent. There does not appear, however, to be a clearly defined medium-to-long term strategy encompassing regulatory, legal (or capital investment) framework for reducing systemic electric power losses. There is a general plan that calls for reforms and restructuring of the power sector and some loosely worded statements that call for reduction in power losses etc., but there is no strategy, plan, or cost estimate that the State has developed that clearly elucidates how they will move from their current position to where they want to be in 5 years.

An Electric Power Regulatory Board comprising a local justice, an economist and some state officials has recently been established. However, due to the relatively nascent state of this Regulatory Board, it is unclear whether they have a charter, have the ability to regulate (or understand tariff issues), or even have the wherewithal to open up tariff and electric power reform to the public-at-large.

Roads and Transport

There are no corporations in the State with respect to transport or roads. The condition of approximately 17,000 Kms of State road network is abysmal. Little or no maintenance has been undertaken in the last few years.

The Secretary of Roads is currently allocating close to 190 crores to transport network development. Of the 190 crores, 100 crores is for operations and general maintenance of existing structures. Approximately, 90 crores will be used for new road/transport network development, or the rehabilitation of existing road/transport networks. The Secretary of Transport stated that approximately 1/3 of every budget over the next three years would be earmarked for rehabilitation/maintenance of existing road networks (approximately 180 crores over 3-years).

The Secretary of Transportation is evaluating whether establishing a toll on vehicles would be an effective method for generating revenue. The amount of the toll is currently being analyzed. In addition, there is peaked interest in Build Operate Transfer (BOT) schemes for road/transport network development. Although there is substantial interest in financing

additional road developments through BOTs there is inadequate knowledge as to how to calculate the benefits/costs, economic and financial rates of returns for BOTs. Further, the State Transportation ministry is also evaluating whether road funds would be effective in the State. The evaluation is not yet finalized.

Privatization

Karnataka and UP have embarked on the first steps of a program on fiscal and governance reform. The main objectives of the State government's public enterprise reform program is to increase efficiency in the use of public resource and reduce the managerial and financial burden on the government through privatization or closure of enterprises that either compete with the private sector or are fundamentally commercial in nature.

There are three types of costs associated with the proposed reform, labor costs, financial restructuring costs of PSEs, and transactions costs. The benefits are quite clear. By selling enterprises and restructuring the remaining enterprises the State(s) hope to sell its equity (raise cash), prevent additional hemorrhaging of precious State fiscal resources, increase local constituency access to services, and more importantly, improve the quality of local service delivery via private sector participation. The pace of privatization is likely to be slow unless increasing emphasis is placed on corporate restructuring, increased cost recovery, and in many instances resolving social safety net issues.

Interventions

From the State fiscal (financial) point of view, there is a need across States to reallocate resources for sectors like infrastructure, water supply, poverty alleviation, and health by reducing non-productive expenditure. At present, a large percentage of the revenue receipt is being utilized for payment of salaries (wages) and subsidies at a time when more funds are required for improving the quality of life of the local (State) constituency. While reforms of the fiscal system can result in the desired allocation of resources in favor of preferred sectors that can spur growth, it is also essential to maximize the value of the money spent.

The primary areas for tactical interventions include:

- Rationalize the role of the State. Any strategy undertaken must seek to refocus government activities on the most critical public goods and services, withdraw from areas where the private sector can be more effective, and to assist and enable the growth of the private sector. In so doing:
 - Develop analytical skills (consultancies) to work with the Divestment Commission, Department of Finance, State Finance Commission or Analytical Cell, to produce privatization or closure strategies for the public enterprises operating in the commercial sector.

- Enhance the effectiveness, transparency, and accountability of the state in carrying out its more focused role. This includes strengthening public expenditure management, improved financial management and accountability systems, allocating resources in line with strategic priorities, and ensuring their efficient and effective use. With respect to current PSEs it is essential to bring in greater management understanding of improving output performance, service delivery, and enhancing expenditure efficiency efforts.
- Part of this strategy must include greater transparency and public participation in the functioning of utilities through right to information, citizen's charters, and service delivery surveys.
- Public relations campaign. Developing a public information campaign to explain to people why it is beneficial to pay for services rendered. The public relations campaign could assist in defining what the cost recovery tariff (water, power etc.) is, what the current level of service is, why it is necessary for the social good and for the stability of State finances to engage in making sure all users pay a cost recovery rate.

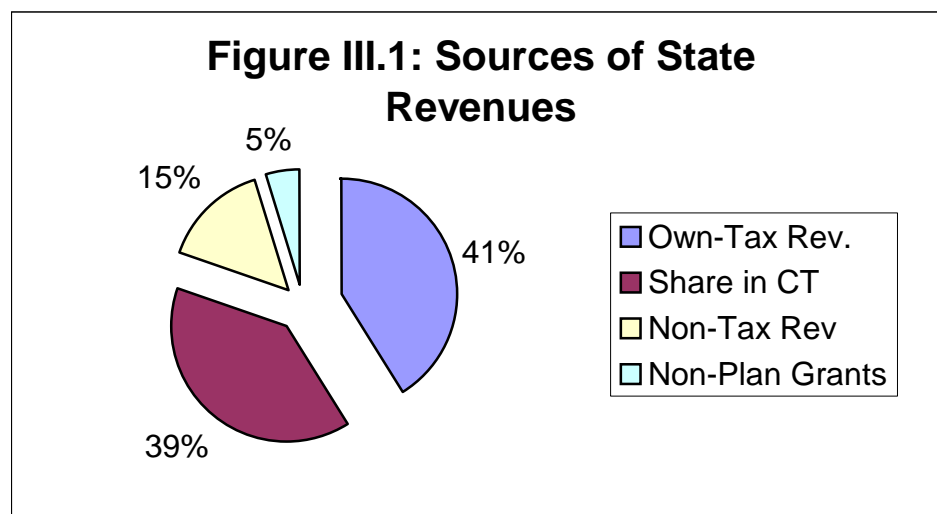
C. Sources of State Revenue

The level of resources available to the States is determined by the efforts of the States to raise tax and non-tax revenue as well as transfers from the Center, specifically shared taxes and non-plan grants. Since this assessment is concerned with potential assistance that USAID could offer selected States, as opposed to the Center, to help them restructure their finances, this section focuses on states' own-source tax. Non-tax revenues, basically user fees for power, water, irrigation, education and health, are taken up in **Annex IV**.

As previously discussed, the strain on State finances experienced in recent years is largely the outcome of the lower growth in revenue and the sharp growth in committed expenditures, such as wages and salaries, pensions and interest payments. These committed expenditures account for a major portion of the non-plan expenditure and together absorb approximately 60 percent of revenue receipts. During the 1990s, the average growth in revenue receipts is estimated to be 13.8 percent, while the growth in expenditure is approximately 15.3 percent. While the States' own tax revenue has shown a marginal improvement from 32.2 percent of the total expenditure during the 1980s to 34.5 percent during the 1990s, the user charges for various socio-economic services provided by the State Governments are very low and transfers from the Center have also declined. The confluence of these factors has resulted in growing revenue deficits of the States.

As shown in Figure III.1 below, the States get the largest share (41 percent) of revenue from own-tax revenue. But, this figure may be misleading. The states' share in total tax collection increased from 33.5 percent in 1989-90 to 38 percent in 1999-00. Upon closer examination it is revealed, however that more than states' applying extra effort in relation to GDP, it is the deterioration of Center's performance in relation to GDP, which has accounted for a larger share of states tax resources. Thus, while gross central taxes in relation to GDP fell from

10.69 to 8.80 percent, state's own tax revenue remained by and large stationary at 5.38 percentage points.



Clearly, maintenance of performance is not enough and this has prompted both the Eleventh Finance Commission and this Advisory Group to assign higher targets for states for their terminal year projections. Thus, Eleventh Finance Commission seeks an improvement of state taxes to 6.44 percent of GDP in 2004-05 and the Advisory Group assuming the same pace of improvement arrives at a target of 6.90 percent in 2006-07. An improvement of the order of 1.52 percentage points envisaged by the Advisory Group over the period 2000-07 is no small task. Higher revenue mobilization is crucially contingent on widening of the tax base and modernizing tax administration.

The states collect state excises, stamps and registration fees and state sales tax. The revenue from state excise is mainly obtained from the tax on liquor. This revenue has stagnated around 0.80 percent of GDP since 1989-90. With increased urbanization and the rise in incomes, however, consumption of alcohol should have gone up several-fold. This suggests that there is significant revenue leakage due to non-compliance and faulty administration. In particular, there appears to be significant revenue leakage in the collection of non-country liquor or Indian made foreign liquor.

Stamp duties and registration fees are not levied mainly with the view to raising revenue except that to some extent the stamp duty on the conveyance of property can be said to be a tax on the value of private wealth. Stamps and registration at present yield only around 0.4 percent of GDP. The rates of duty on conveyance of property should be moderate, but the moderate rates should be combined with proper valuation. High rates of duty induce avoidance as well as under-valuation of property. Valuation of property by experts is extremely important. In each state there should be an independent valuation cell, manned by personnel outside of the registration department. Finally, all property records and transactions in the department of registration should be computerized for quick action.

The sales tax forms the main source of revenues for states, comprising about 60 percent of the total tax revenue of the states. However, the regime of sales tax in the states is characterized by the following basic problems:

1. "First point" taxation at the manufacturer and importer levels leads to a narrow base due to the exclusion of the value addition at the subsequent stages of trade, from the taxable base. It also leads to discrimination amongst goods, depending on the number of states they go through in the course of production and trade, and also the relative proportion of value added at the subsequent stages of sale. It is also not possible to discriminate between purchases for intermediate use and those for final consumption. This results in cascading, excess burden and distortions in economic decisions. It also faces definitional and evaluation problems which unnecessarily complicate compliance and administration.
2. Sales tax is constricted by the exclusion of services from its purview. The state can levy tax only on a few specified services like luxuries, entertainment, amusements, bettings and gambling, and on goods and passengers carried by road and inland waterways. However, the general power to tax services does not lie with states. This has been a source of acute problems in taxing even the sale of goods where the sale takes place as an integral part of providing the service.
3. Multiplicity of levies, rates and concessions results in lack of transparency, hairsplitting distinctions among commodities and breeds excessive litigation and economic distortions. With a narrow base the tax rates also have to be high to garner the same amount of revenue in comparison to what would be otherwise needed. High rates tend to induce evasion and also generate pressures for concessions and exemptions for particular sectors of the economy and sections of the community. In turn, this lead sot multiplicity of tax rates, with distinctions between commodities that are difficult to draw in practice, resulting in an excess burden from disputes relating to classification.
4. Wide divergence in the structure and procedure across states creating handicaps for doing business in more than one state. Each state has its own legislation, with its own taxable base, formulae for tax calculations and reporting requirements.
5. Taxation of inter-state sales on origin basis permits tax exporting. The levy of a tax on inter-state sales through mechanism of central sales tax (CST) distorts the location of industries and the flow of internal trade impedes the growth of a common market in the country.
6. Absence of coordination and lack of information sharing among the states leads to a high level of tax evasion on inter-state transactions.

It is, therefore, well recognized that internal trade transactions in both excises and the sales tax have been a source of inequity as well as distortion and inefficiency in economic decisions and resource allocation impeding growth and the competitive strength of Indian

industry. Consequently, the states have collectively decided to reform the existing state sales tax regime by implementing a state-level VAT.

In its purest form, VAT is a tax that is levied on the value added along different stages of production and distribution of a commodity or service. Therefore, it is a tax on the sum total of value added (i.e., equal to value of a commodity or service). In this sense, it should be equivalent to a retail sales tax that is collected only at the retail stage. But the retail sales tax is difficult to collect because there are too many retailers of various sizes. The VAT, instead, can be collected at earlier stages of production in fragments and can end at the retail stage. But the total collected from the VAT should be exactly the same if collected only from the retailers of the commodity concerned. In addition, the advantages of a VAT relative to a retail sales tax or the sales tax now in place among the States of India include the following: eliminates cascading effect; eases administration; improves international competitiveness; and imparts transparency.

Clearly, the states need to improve tax policy and administration. In particular, the states would benefit from assistance with VAT implementation, computerization of property records and transactions, and development of a professional cadre for property valuation, etc. As is well known, tax administration can make or break tax policy. In India, by and large, no serious effort has been made to modernize tax administration, although some improvements have been taken in recent years. The administration of all taxes is based largely on traditional methods, is largely manual based and has fallen far behind the tax administration in advanced countries in terms of efficiency, helpful approach to the taxpayers and standards of equity. The state governments have not thought fit to push through vigorously reform of the tax administration partly because of lack of understanding of how much an obstacle it is to the smooth functioning of the economy and of the significant part it plays in their ability to obtain efficiently increasing revenues. As things stand today a thorough reform and modernization of the administration of the major taxes is the most important method and requirement for increasing tax revenues along with growth. In short, reform and modernization should include substituting a sub-national VAT for the current state sales tax regime; computerization of tax administration; reducing leakage of revenue; and removing exemptions, concessions and preferential rates.

Although USAID has supported tax policy and administration reforms in many transitional and developing countries and despite the need for such reforms among the states, we do not recommend that USAID get involved in this activity for the following reasons.

This is a very expensive activity. The resources that USAID will make available to this activity probably are not sufficient to the task at hand. Of course, it could be made to work despite USAID's resource constraints. For example, USAID could work in a small state that is willing to use its own money for the purchase of hardware, say Jharkand, and USAID could furnish targeted technical assistance and training for software development, tax policy design and improved tax administration. The problem with this strategy is that Jharkand has adequate revenues and, as such, should probably focus its efforts on improved expenditure management rather than improved resource mobilization. Alternatively, USAID could work in partnership with a multilateral donor (i.e., Asia Development Bank and the World Bank), again providing targeted technical assistance and training in the areas identified above. In the case of Uttar Pradesh, for example, the head of the revenue department, Mr. Joseph, was quite clear that he did

not require any assistance from USAID. Nevertheless, this is probably an isolated case and other states receiving multilateral assistance, such as Karnataka, Kerala, among others, would welcome assistance from USAID.

There is simply too much uncertainty surrounding the implementation of sub-national VAT. Although implementation of the VAT should begin on April 1, 2002, at the time of writing (early November, 2001) there are still fundamental debates about the treatment of services, inter-state trade and grandfathering of existing sales tax concession and preferences. Until these issues are resolved, the implementing legislation cannot be finalized and form design, registration and training cannot begin in earnest until the implementing legislation is finalized. According to the timetable for VAT recommended by the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan provided below as Table III.5, drafting of the VAT legislation should have been completed by the end of July, 2001. Clearly, this has not been accomplished at the time of this writing. Therefore, it seems reasonable to assume that there will be further slippage in this timetable. If USAID decides to assist with VAT implementation in one or more states despite the expense and uncertainty, the VAT timetable provides a comprehensive list of potential interventions.

Table III.5: State Sources of Revenue (Rs. crores)

State	Own-Tax Rev.	Share in CT	Non-Tax Rev	Non-Plan Grants	Total	GSDP
Andra Pradesh	7,961	3,008	1,847	158	12,975	113,381
Armalchat Pradesh	11	269	65	38	383	1,609
Assam	983	1,349	452	307	3,090	29,780
Bihar	2,672	4,441	1,146	350	8,609	75,874
Goa	357	97	343	7	805	5,003
Gujarat	7,616	1,642	2,766	155	12,179	105,838
Haryana	3,120	480	945	47	4,592	44,826
Himachal Pradesh	572	727	205	62	1,567	8,941
Jammu & Kashmir	437	1,212	283	342	2,273	10,941
Karnataka	6,943	1,924	1,437	105	10,409	88,154
Kerala	4,650	1,382	464	91	6,587	57,414
Madhya Pradesh	5,108	2,932	1,782	194	10,017	102,391
Maharashtra	14,202	2,922	3,551	148	20,824	238,348
Manipur	31	332	31	69	463	1,876
Meghalaya	88	301	51	33	473	3,058
Mizoram	9	280	36	25	350	1,331
Nagaland	35	437	43	77	592	2,342
Orissa	1,487	1,695	557	68	3,807	39,038
Punjab	3,262	587	1,500	92	5,442	57,463
Rajasthan	3,939	1,964	1,347	332	7,583	70,097
Sikkim	28	111	43	0	182	784
Tamil Nadu	9,625	2,409	1,123	162	13,319	119,329
Tripura	84	457	45	80	666	3,755
Uttar Pradesh	7,910	5,771	1,475	184	15,340	171,804
West Bengal	4,774	2,692	371	351	8,189	109,993
Total	149,419	67,513	40,804	6,178	263,914	2,926,738

Table III.6: Source of State Revenue as a Share of Total State Revenue (Percentage)

State	Own-Tax Rev.	Share in CT	Non-Tax Rev	Non-Plan Grants	Total
Andra Pradesh	61	23	14	1	100
Armalchat Pradesh	3	70	17	10	100
Assam	32	44	15	10	100
Bihar	31	52	13	4	100
Goa	44	12	43	1	100
Gujarat	63	13	23	1	100
Haryana	68	10	21	1	100
Himachal Pradesh	37	46	13	4	100
Jammu & Kashmir	19	53	12	15	100
Karnataka	67	18	14	1	100
Kerala	71	21	7	1	100
Madhya Pradesh	51	29	18	2	100
Maharashtra	68	14	17	1	100
Manipur	7	72	7	15	100
Meghalaya	19	64	11	7	100
Mizoram	3	80	10	7	100
Nagaland	6	74	7	13	100
Orissa	39	45	15	2	100
Punjab	60	11	28	2	100
Rajasthan	52	26	18	4	100
Sikkim	16	61	24	0	100
Tamil Nadu	72	18	8	1	100
Tripura	13	69	7	12	100
Uttar Pradesh	52	38	10	1	100
West Bengal	58	33	5	4	100
All India Average	41	39	15	5	100

Table III.7: Source of State Revenue as a Share of GSDP (Percent)

State	Own-Tax Rev.	Share in CT	Non-Tax Rev	Non-Plan Grants	Total
Andra Pradesh	7	3	2	0	11
Armalchat Pradesh	1	17	4	2	24
Assam	3	5	2	1	10
Bihar	4	6	2	0	11
Goa	7	2	7	0	16
Gujarat	7	2	3	0	12
Haryana	7	1	2	0	10
Himachal Pradesh	6	8	2	1	18
Jammu & Kashmir	4	11	3	3	21
Karnataka	8	2	2	0	12
Kerala	8	2	1	0	11
Madhya Pradesh	5	3	2	0	10
Maharashtra	6	1	1	0	9
Manipur	2	18	2	4	25
Meghalaya	3	10	2	1	15
Mizoram	1	21	3	2	26
Nagaland	2	19	2	3	25
Orissa	4	4	1	0	10
Punjab	6	1	3	0	9
Rajasthan	6	3	2	0	11
Sikkim	4	14	5	0	23
Tamil Nadu	8	2	1	0	11
Tripura	2	12	1	2	18
Uttar Pradesh	5	3	1	0	9
West Bengal	4	2	0	0	7
All India Average	5	2	1	0	9

Table III.8: VAT Timetable

	2001												2002			
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
1 Leg & Rules																
Finalize draft tax law																
Auxiliary law																
Draft rules																
Ministry of Law review																
Law returned to CCT																
Review by Cabinet																
Ordinance and Gazetting																
2 Publicity																
Private sector discussion																
Private sector consult on operations																
Copies for trade/professions																
Seminar for trade/professions																
Finalize VAT guide																
Finalize registration leaflet																
3 Advertising																
Registration advertising																
Implementation advertising																
Payment advertising																
4 Organizational																
Staff to VAT cell																
Organizational structure																
Finalize number of taxpayers																
Staff to administer																
Manager and Supervisors																
Auditors & Processors																
Date entry staff																
Debt collection staff																
5 Operational																
Design audit system																
Design registration system																
Returns/Payment/Processing system																
6 Forms																
Finalize registration application form																
Finalize registration certificate																
Finalize return form																
Print registration application form																
Print registration certificate																
Print return form																

Table III.8 (continued): VAT Timetable

	2001												2002			
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
7. Computer Development																
Decide computer allocation																
Complete user specs registration system																
Develop registration system																
Test registration system																
Load final registration data base early sup																
Complete user specs. On going system																
Develop ongoing system																
Test and develop ongoing system																
8. Manuals																
Prepare initial staff manual																
Prepare supplemental manual																
Prepare audit and compliance manual																
9. Training delivery																
Preliminary training																
General training																
Audit training delivery																
10. Registration and implementation																
Issue registration application forms																
Issue registration certificates																
Conduct advisory visits																
Issue first return forms																
Receive first payments																
Identify defaulters																
Pursue defaulters																
11. Monitoring cell																
Follow price movements																
Inform traders																
Action taken																

Source: Report of the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan, May 2001

D. Debt Management of the Indian States

(add footnote us US dollar equivalent of Indian currency when first mentioned)

Introduction

The fiscal position of the States has been under stress since the mid-eighties, mainly on account of inadequacy of revenue receipts in meeting the growing expenditure requirements. While the State governments collect about one-third of the consolidated Government sector receipts, they incur more than three-fourths of the total expenditure on social services and more than half of the total expenditure on economic services. Thus, there is a serious imbalance between the revenue needs and revenue receipts of the States.

The founding fathers of the Indian Constitution were, indeed, quite aware of the imbalance between the expenditure responsibilities of the States and the revenue source assigned to them. As a result, constitutionally ordained revenue transfer from the Center to the States take place on the recommendations of the Finance Commission. Further, significant transfers for development activities have been taking place through the Planning Commission. The quantum of revenue transfers from the Center, however, critically depends on the fiscal health of the Union Government. Moreover, a considerable share of transfers through the Planning Commission is in the form of loans, which adds to the debt burden of the States

The level of resources available to the State is determined by the efforts of the States to raise tax and non-tax revenues as well as resource transfers from the Center. The States' own tax revenues have shown only a marginal improvement from 32.2 percent of the total expenditure during the 1980s to 34.5 percent during the 1990s. The internal resource mobilization by the States has been further constrained by losses incurred by the State Public Sector Undertakings, especially State Electricity Boards (SEBs) and State Road Transport Corporations (SRTC's). The user charges for various socio-economic services provided by the State Governments are abysmally low and are often wiped out by the heavy losses of the irrigation departments on account of negligible water charges. During the 1990s, resource flow from the Center has also shown some deceleration on account of its own fiscal constraints in the context of economic reforms initiated in 1991.

Thus, while the internal resources of the States have not shown adequate buoyancy, inadequate resource transfers from the Center has adversely affected the balance in the revenue account of the States. The resulting imbalance in the revenue account along with borrowings for investments has led to debt accumulation over time. The high and growing volume of debt has resulted in ever-increasing interest burden. The sustainability of high-level debt stock, its composition and rising burden of interest payments are all matters of serious concern. There is an imperative need to examine these issues in order to find ways to resolve them.

Analysis of Trends in Interest Payments

The consolidated interest payments of the State governments had increased significantly from Rs.8655 crore in 1990-91 to Rs.21933 crore in 1995-96 and further to Rs.54031 crore in 2000-01. Thus, over the last 10 years, the interest burden of the States increased more than 620 percent in nominal terms. While the increase in interest liability during the first half of the decade was mainly due to the increase in cost of funds resulting from financial sector reforms and market related interest rates for Government borrowing, the growth in the second half of the decade was mainly on account of growth in debt.

Table III.9 : Interest Burden of State Governments
(Amount in Rs. Crore, ratio in percent)

Year	Interest payment	Interest payment Revenue Expenditure	Interest payment Revenue Receipts	Interest payment GDP
1990-91	8655	12.1	13.0	1.5
1991-92	10944	12.7	13.6	1.7
1992-93	13210	13.7	14.5	1.8
1993-94	15801	14.4	15.0	1.9
1994-95	19413	15.1	15.9	1.8
1995-96	21933	15.1	16.0	1.9
1996-97	25577	15.1	16.7	1.9
1997-98	39113	16.1	17.7	2.0
1998-99	35874	16.3	20.3	2.0
1999-2000	45172	17.3	21.8	2.3
2000-01	54031	18.0	21.6	2.5

Source: Derived from Reserve Bank of India statistics.

The proportion of interest payments to revenue expenditure has increased secularly from 12.1 percent in 1990-91 to 18.0 percent in 2000-01. Similarly, the proportion of interest payments to revenue receipts has also shown a sharp rise over the same period (by over two-thirds) from 13 percent to almost 22 percent. The interest liability as a percentage of GDP has also increased steadily from 1.5 to 2.5 percent over the decade. The growing interest burden has put severe pressure on State finances accounting for a significantly high proportion of revenue expenditure and pre-empting a substantial share of revenue receipts (Table III.9 and Chart III.5).

Put Chart III.5 here

The Statewise data on interest payments-revenue receipts ratio for the 11-year period 1990-2001 are presented in Annexure III.1. It is evident from Annexure III.1 that the interest payments-revenue receipts ratio varies considerably across the States and the variation has widened over the years. For example, during 1990-91 the ratio ranged between 4.3 percent for Arunachal Pradesh to 18.9 percent for Jammu and Kashmir. By comparison, during 2000-01 the inter-state variation (?) increased sharply ranging between 8.3 percent for Sikkim to 40.2 percent for West Bengal. Table III.10 clearly brings out the over-time change in the inter-state disparity in the ratios during the 1990s.(confusing two sentences)

Table III.10: Distribution of States According to Ratio of Interest Payment to Revenue Receipts (No. of States)

Years	Below 10 percent	10-15 percent	15-20 percent	Above 20 percent	Total
1990-91	6	16	3	0	25
1991-92	9	7	8	1	25
1992-93	4	12	8	1	25
1993-94	4	9	1	1	25
1994-95	5	10	6	4	25
1995-96	6	10	8	1	25
1996-97	5	10	7	3	25
1997-98	4	11	5	5	25
1998-99	3	13	5	4	25
1999-2000	3	10	7	5	25
2000-2001	1	9	9	6	25

Source: Compiled from data in Annexure III.1

Data in Annexure III.1 reveal certain other uncomfortable trends as far as State debt servicing burden is concerned. Some of the major States that had relatively low debt servicing burden at the beginning of the decade experienced very fast growth in the ratio of interest payments to revenue receipts. The most spectacular case is that of West Bengal where the

Annexure III.1: Details of Interest Payments-Revenue Receipts Ratios Per State (in percent)

States	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000(RE)	2000-2001(BE)
Andhra Pradesh	11.0	11.1	11.7	12.4	14.3	15.5	16.4	15.6	18.5	18.6	18.9
Arunachal Pradesh	4.3	4.8	4.3	5.0	5.7	5.6	6.6	7.2	7.7	8.0	9.8
Assam	14.8	3.8	15.7	14.8	19.9	14.4	14.5	14.8	11.6	18.6	15.2
Bihar	17.4	20.7	20.8	20.4	23.0	22.6	17.6	17.7	20.2	22.7	22.6
Goa	10.6	17.8	15.0	14.7	12.9	11.0	12.4	10.7	12.5	14.0	12.5
Gujarat	15.7	15.4	15.7	14.9	15.3	15.5	16.7	16.9	17.8	19.5	21.1
Haryana	12.6	14.4	14.4	12.1	8.3	11.1	11.8	13.9	18.2	22.0	22.8
Himachal Pradesh	13.7	14.9	16.8	14.3	17.0	16.3	15.7	17.1	21.5	17.9	29.9
Jammu & Kashmir	18.9	23.7	17.5	12.4	19.1	13.5	13.3	13.8	14.7	15.0	18.3
Karnataka	11.2	10.8	11.0	11.4	12.5	12.3	12.6	13.1	14.4	15.6	15.4
Kerala	14.2	16.9	16.3	17.5	17.6	17.0	18.0	18.1	20.1	19.6	18.9
Madhya Pradesh	11.3	11.3	11.5	12.3	14.4	13.4	13.7	14.7	16.2	16.3	18.1
Maharashtra	10.1	11.9	12.4	11.6	11.7	12.4	12.7	14.3	16.9	19.1	21.4
Manipur	7.7	6.9	9.3	8.4	8.7	8.3	8.1	9.1	10.2	11.1	14.5
Meghalaya	5.1	5.3	5.9	6.7	8.5	7.4	7.6	8.7	8.3	12.1	11.9
Mizoram	7.2	3.3	6.6	4.5	5.5	5.6	7.1	9.1	10.0	10.4	14.5
Nagaland	10.4	10.8	11.3	9.7	12.7	10.2	11.2	11.4	13.2	14.3	14.7
Orissa	16.8	19.7	18.6	21.3	22.0	23.9	25.2	27.9	32.6	27.3	30.1
Punjab	16.8	9.7	14.7	31.8	23.5	28.7	29.4	29.1	40.3	29.5	27.4
Rajasthan	13.7	14.9	15.2	15.8	16.4	16.2	20.5	22.6	26.1	28.7	29.8
Sikkim	6.5	8.2	9.0	9.7	4.8	3.1	2.9	3.1	3.6	4.6	8.3
Tamil Nadu	9.0	8.2	9.8	11.9	11.8	12.2	12.3	13.0	14.9	15.7	14.9
Tripura	7.7	8.9	9.7	10.6	10.2	9.5	10.7	11.1	11.1	12.3	12.6
Uttar Pradesh	15.4	17.7	17.5	17.4	23.1	21.9	25.3	26.7	31.7	29.8	29.7
West Bengal	15.3	17.7	18.5	19.7	19.3	21.9	23.6	26.7	31.4	35.9	40.2
NCT Delhi	-	-	-	-	-	4.1	6.8	9.0	11.8	11.5	12.6
All States	13.0	13.6	14.5	15.0	15.9	16.0	16.7	17.7	20.3	21.2	22.2

Source: RBI Bulletin on State Finances: Various Issues

growth was from 15.3 percent to over 40 percent. Indeed, most of the growth in interest burden occurred in the second half of the 1990s when it almost doubled. The other major States that experienced fast growth are Uttar Pradesh, Rajasthan, Orissa and Maharashtra. In all these States, faster growth took place in the second half of the 1990s. The principal reason for this fiscal deterioration has been the steep increase in borrowings to finance the increased revenue expenditure on account of salary revision in the face of stagnating revenues. (convert into two sentences for clarity)

Analysis of the Structure of Interest Liabilities

Important sources of capital receipts for the States are: 1) loans from the Center; 2) market borrowings; 3) PF, small savings, etc. and 4) others. In addition, to tide over the temporary mismatch in receipts and payments, the Reserve Bank extends Ways and Means Advances and Overdrafts to States. Among the categories mentioned above, loans from the Center form the most important constituent item. The Government of India extends loans to States, which are mainly under two broad categories: 1) Plan loans and, 2) Non-plan loans. The Plan loans comprise State plan loans, drought loans, Central sector loans, loans for Centrally sponsored schemes and others. The non-plan loans comprise shares in small savings collection, relief for natural calamities and others.

Among Plan Loans, the State Plan Loans account for a major portion of the total interest payments. One of the constituent items under State plan loans is the external assistance obtained through the Center from lending institutions/foreign governments and passed on to State Governments under the head Additional Central Assistance (ACA). The ACA is extended to States on the same terms and conditions as Central Plan Loans. Irrespective of the rate of interest charged by the donor agencies to the Government of India, the loan component of the ACA carries the same rate of interest as the loan component of the normal State Plan Assistance, which is 12.0 percent per annum at present.

In the Non-Plan Loan category, loans against small savings collection constitute a sizeable portion. With effect from April 1, 1999, there has been a change in the accounting procedure of net small savings collections and allocation of the same to the States. Under the revised procedure, the small savings collections are credited to the national Small Savings Fund (NSSF) in the Public Account. All withdrawals of small savings by depositors come out of the Fund. The balances in the Fund are invested in the Central and State securities. Accordingly, small savings have been delinked from the Center's fiscal deficit. The share of States/Union Territories in the net small savings and PF collections has been enhanced from 75 to 80 percent with effect from January 15, 2000.

The interest on loans from the Center constitutes the major portion of the total interest payments of State Governments. However, the share of interest payments on loans from the Center in the total interest payments has been continuously declining during the 1990s. It declined from 59.8 percent in 1990-91 to 55.1 percent in 2000-2001 (BE). The share of market loans and PF small savings, etc., on the other hand, showed a mixed trend. While the share of market loans in total interest payments rose from 15.5 percent in 1990-91 to 19.0 percent in

1996-97 and then steadily declined to 17.6 percent in 2000-01(BE), the share of provident funds, small savings etc., declined from 19.9 percent in 1990-91 to 14.9 percent in 1997-98 and then rose to 16.8 percent in 2000-01 (BE). In contrast, the share of 'Other loans' has been continuously rising from 5 percent in 1990-91 to 10.5 percent in 2000-01 (Table III.11).

Table III.11: States' Interest Liabilities on Loans: Per Component
(Rs. Crore)

Year	Loans from Center	Market loans	Provident funds, small savings etc.	Others	Total
1990-91	5178(59.8)	1343(15.5)	1703(19.7)	431(5.0)	8655(100.0)
1995-96	13057(59.5)	3430(15.6)	3888(17.7)	1557(7.1)	21932(100.0)
1996-97	15155(59.3)	4868(19.0)	4069(15.9)	1484(5.8)	25576(100.0)
1997-98	17514(58.2)	5648(18.8)	4488(14.9)	2463(8.2)	30113(100.0)
1998-99	20892(58.2)	6514(18.2)	5513(15.4)	2955(8.2)	35874(100.0)
1999-2000(RE)	25706(56.5)	8300(18.2)	7663(16.8)	3857(8.5)	45526(100.0)
2000-2001(BE)	29892(55.1)	9578(17.6)	9122(16.8)	5679(10.5)	54271(100.0)

Note: Figures in parenthesis represent percentage to total

Source: RBI bulletin on State Finances: Various issues.

The State share of interest payments according to various components in 1990-91 and 2000-01 are presented in Annexure III.2. The share of interest payments on loans from the Center in total interest payments declined in the case of all States, except Kerala and Bihar. The share of interest payments on market loans in total interest payments increased in the case of 21 States, while it declined in case of 4 States between 1990-91 and 2000-01. The share of interest payments on PF, small savings etc., in total interest payments increased in the case of 9 States, while it declined in the case of 16 States between 1990-91 and 2000-01.

Annexure III.2: Share of Various Components of Interest Payment: Per State

States	Loans from Center		Market loans		PF, Small savings		Others	
	1990-91	2000-01	1990-91	2000-01	1990-91	2000-01	1990-91	2000-01
Andhra Pradesh	54.5	52.01	25.0	27.08	18.1	9.48	2.4	11.44
Arunachal Pradesh								
Assam	56.4	48.41	0.0	8.30	36.7	24.78	6.9	18.51
Bihar	83.3	59.18	7.9	26.43	7.5	10.14	1.3	4.25
Goa	53.7	60.84	16.4	21.89	28.6	16.85	1.3	0.42
Gujarat	64.7	47.93	5.8	15.38	24.0	21.87	5.5	14.82
Haryana	74.5	74.15	8.1	11.84	13.3	11.78	4.1	2.23
Himachal Pradesh	49.3	49.12	15.1	13.46	26.0	27.89	9.6	9.53
Jammu & Kashmir	53.7	46.09	7.3	11.37	32.9	25.36	6.1	17.08
Karnataka	68.0	0.0	0.0	0.00	26.0	0.0	74.0	100.00
Kerala	57.3	51.52	18.3	18.98	20.4	17.13	4.0	12.37
Madhya Pradesh	40.6	40.80	23.6	27.69	30.7	23.96	5.3	7.55
Maharashtra	55.8	52.31	11.8	20.28	27.1	18.83	5.3	8.58
Manipur	68.8	60.27	7.8	10.04	21.2	26.92	2.2	2.77
Meghalaya	33.6	30.99	23.2	19.62	30.4	34.12	12.8	15.27
Mizoram	67.1	35.14	12.7	37.41	14.7	12.99	5.5	14.46
Nagaland	96.7	29.87	0.0	17.48	0.0	32.33	3.3	20.32
Orissa	42.6	20.64	20.9	36.55	23.8	24.68	12.7	18.13
Punjab	50.0	47.96	23.4	23.73	23.7	21.93	2.9	6.41
Rajasthan	66.4	63.55	8.3	9.51	22.2	17.47	3.1	9.47
Sikkim	50.0	45.70	19.1	20.81	26.4	26.31	4.5	9.18
Tamil Nadu	100.0	33.86	0.0	30.20	0.0	25.31	0.0	10.63
Tripura	54.1	49.28	24.1	22.94	11.9	18.74	9.9	9.04
Uttar Pradesh	48.4	38.60	19.1	18.29	22.2	33.25	10.3	9.86
West Bengal	59.0	50.77	18.2	20.52	13.8	13.24	9.0	15.47
	71.2	67.77	15.0	12.73	8.0	5.68	5.8	13.83
Total	59.8	55.08	15.5	17.65	19.7	16.81	5.0	10.46

Source: RBI bulletin on State Finances

Outstanding Debt

The interest burden on States is determined by the stock of States' debt and the rate of interest on the same. During the 1990s, there has been a sharp increase in the States' outstanding debt on account of rising level of fiscal deficit. In addition, there has been a rise in the rate of interest due to market related interest rates.

The outstanding stock of debt of State Governments has risen sharply during the 1990s from Rs.110,289 crore at end-March 1991 to Rs.504,248 crore at end-March, 2001 (RE). Along with the overall magnitude, the composition of the States' liabilities has also undergone a change. The details of the outstanding liabilities of the State Governments per component are set out in Table III.12. While the share of loans from the Center has declined from 67.2 percent in 1990-91 to 57.3 percent in 2000-01, the shares of market loans, Provident Fund, small savings etc., and other loans have gone up during this period.

Table III.12: Outstanding Liabilities of the State Governments: Per Component

(Rs. Crore)						
Year	Loans from Center	Market loans	P.F.Small savings	Others	Total	Debt-GDP ratio
1990-91	74117(67.2)	15618(14.2)	16961(15.4)	3593(3.3)	110289(100.0)	19.4
1991-92	83491(66.1)	18923(15.0)	19870(15.7)	4054(3.2)	126338(100.0)	19.3
1992-93	92412(65.0)	22426(15.8)	23492(16.5)	3848(2.7)	142178(100.0)	19.0
1993-94	101945(63.7)	26058(16.3)	27822(17.4)	4252(2.7)	160077(100.0)	18.6
1994-95	116705(63.2)	30133(16.3)	32601(17.7)	5088(2.8)	184527(100.0)	18.2
1995-96	131505(62.0)	36021(17.7)	37502(17.7)	7197(3.4)	221225(100.0)	17.9
1996-97	149053(61.2)	42536(17.5)	42878(17.6)	9058(3.7)	243525(100.0)	17.8
1997-98	172729(61.4)	49816(17.7)	49103(17.5)	9559(3.4)	281207(100.0)	18.5
1998-99	203786(59.6)	60283(17.6)	61072(17.9)	16837(4.9)	341978(100.0)	19.4
1999-2000						
	243665(58.2)	72112(17.2)	78298(18.7)	24507(5.9)	420132(100.0)	21.4
2000-01(RE)	285824(57.3)	83783(16.8)	93036(18.7)	36196(7.3)	504248(100.0)	23.1
Average annual growth rate	14.3	18.6	19.0	24.7	16.1	-

Note: Figures in brackets indicate percentage share in the total

Source: RBI Bulletin on State Finances: Various Issues.

The debt-GDP ratio declined secularly from 19.4 percent in 1991-92 to 17.8 percent in 1996-97, but increased thereafter reaching a level of 23.1 percent in 2000-01 (RE), reflecting larger rise in debt stock in recent years. This steep increase in debt-GDP ratio was on account of the massive jump in State borrowings to meet the revenue gap arising from rising expenditure in the face of stagnant revenues. As a result, the consolidated outstanding debts of the States more than doubled in just four years.

The sharp rise in the States' debt has been on account of rising levels of fiscal deficit during the 1990s. The gross fiscal deficit (GFD) of the State Governments rose from Rs 18,787 crore in 1990-91 to Rs.95,277 crore in 2000-01. As a proportion of GDP, the GFD increased from 3.3 percent in 1990-91 to peak at 4.7 percent in 1999-2000 but declined to 4.4 percent in 2000-01. The major share of borrowings in the recent past was used to fill the growing revenue gap. As a result, the revenue deficit has been growing at a much faster rate than GFD. The revenue deficit increased almost 10 times over the past ten years from Rs.5309 crore in 1990-91 to Rs.51318 crore in 2000-01. As a proportion of GDP, revenue deficit increased from 0.9 percent in 1990-91 to 2.7 percent in 1999-2000, but declined marginally to 2.3 percent in 2000-01.

[Put Chart III.6 here](#)

The State debt: GDP ratios per year from 1989-90 to 2000-01 are presented in Annexure III.3. The debt figures are as on the last Friday of March, every year. The GDP figures used are Gross Domestic Products of factor cost.

Annexure III.3 Debt GDP Ratios Per State (in percent)

State	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00RE	2000-01 BE
<u>SPECIAL CATEGORY STATES</u>												
1. Arunachal Pradesh	58.74	66.93	58.19	61.67	55.86	58.74	53.03	53.68	52.07	51.70	51.70	50.67
2. Assam	41.86	39.87	37.90	33.97	29.48	28.74	29.23	29.36	29.12	28.61	30.91	31.94
3. Himachal Pradesh	41.01	35.42	44.08	42.94	42.64	47.52	55.14	55.39	57.27	73.69	78.93	81.57
4. Jammu & Kashmir	95.79	98.92	89.93	86.84	73.49	68.67	68.38	69.57	71.71	69.25	73.98	73.97
5. Manipur	44.44	43.12	43.31	40.71	36.39	34.48	35.11	33.17	42.80	50.82	60.79	59.96
6. Meghalaya	24.70	23.26	22.85	23.09	24.36	27.35	23.52	23.76	24.64	27.89	32.20	35.12
7. Mizoram	66.99	35.78	33.55	43.53	44.78	48.96	49.41	41.34	43.26	47.55	52.22	54.68
8. Nagaland	60.92	66.87	60.05	54.14	56.98	58.55	58.53	55.54	55.37	57.39	61.13	60.87
9. Sikkim	55.39	61.11	64.09	71.91	59.39	56.74	58.44	58.96	60.04	75.79	86.22	92.25
10. Tripura	42.09	46.17	46.87	56.30	48.16	50.60	48.16	50.49	53.12	58.54	67.76	76.35
<u>NON SPECIAL CATEGORY STATES</u>												
1. Andhra Pradesh	19.80	20.23	19.48	20.68	20.31	20.20	20.34	20.44	22.59	24.15	27.05	30.55
2. Bihar	34.48	34.93	36.56	38.21	36.81	36.48	40.07	36.52	36.30	37.28	40.69	43.48
3. Goa	59.49	67.30	58.09	51.07	45.21	43.23	38.19	36.03	38.18	40.68	42.79	45.27
4. Gujarat	21.53	22.25	23.08	19.50	19.02	16.38	16.82	16.70	17.39	19.13	21.00	22.35
5. Haryana	20.84	20.69	19.53	20.64	20.13	19.34	20.76	19.14	20.39	22.65	24.78	26.31
6. Karnataka	20.01	19.88	17.72	18.60	19.04	19.23	19.39	19.54	19.76	21.05	22.75	24.76
7. Kerala	28.67	31.51	29.61	29.62	31.97	32.76	31.57	30.75	29.63	32.28	34.90	35.80
8. Madhya Pradesh	23.41	21.41	23.34	22.53	21.33	21.19	21.51	21.48	22.65	24.29	25.76	26.96
9. Maharashtra	15.43	15.29	15.51	13.99	12.96	12.79	12.15	12.67	14.19	15.27	17.16	17.48
10. Orissa	35.56	41.55	37.60	40.49	40.24	38.99	39.04	47.09	45.82	49.67	53.36	58.04
11. Punjab	32.73	36.32	34.55	36.04	33.82	34.19	33.90	33.36	34.19	37.01	38.99	40.01
12. Rajasthan	32.92	27.70	28.45	27.38	30.49	27.31	29.06	29.00	30.56	35.05	38.41	41.08
13. Tamil Nadu	17.05	17.55	17.66	17.96	17.98	18.40	18.57	18.15	18.63	20.01	21.19	22.51
14. Uttar Pradesh	26.34	27.38	27.32	28.44	28.95	29.43	29.53	29.35	30.78	33.40	35.97	37.56
15. West Bengal	20.80	22.62	22.19	22.81	22.83	21.89	22.20	22.81	24.63	29.55	32.93	37.63
ALL STATES	24.85	25.17	24.91	24.65	24.07	23.60	23.71	23.67	24.80	27.01	29.41	31.28

The debt-GSDP ratio for alls States had been gradually declining since 1990-91 until 1994-95 and remained stable at that level until 1996-97. Since 1996-97, there was a steep growth in this ratio by 32 percent, from 23.7 percent to 31.3 percent.

Individual State ratios show more or less similar trends, though there are a few exceptions. Thus, for example, States like Himachal Pradesh, Meghalaya and Tripura among Special Category States, and Bihar, Kerala, Punjab, Tamil Nadu and Uttar Pradesh among Non-special Category States experienced increase in debt-GSDP ratios during the first period as against the reverse trend for all States taken together. However, for the second period, Arunachal Pradesh was the only exception to the rule of increasing debt-GSDP ratios. The States that experienced an exceptionally large increase in outstanding debt during the recent past in relation to GSDP are Himachal Pradesh, Manipur, Sikkim and Tripura among Special Category States, and Andhra Pradesh, Maharashtra, Rajasthan, Uttar Pradesh and West Bengal among the major States.

To place things in the right perspective it is worth mentioning that the apparently unsustainable debt: GSDP ratios attained by most of the Special Category States may not be as

damaging as the steep increase in the debt burden of major States, such as Andhra Pradesh, Maharashtra, Uttar Pradesh and West Bengal, from the point of view of the overall debt burden of the nation. For example the outstanding debt of Uttar Pradesh alone accounted for 14 percent of the total debt of the States at the end of March 2001 and the total of four States viz., Andhra Pradesh, Maharashtra, Uttar Pradesh and West Bengal, accounted for 40 percent of the total. By comparison, the nine Special Category States, other than Assam, together accounted for just 5 percent of the State debts.

Contingent Liabilities

So far this report has focused solely on direct-debts of the States. The fiscal position of the State Governments is also affected by the nature and levels of contingent liabilities, which include guarantees, indemnities etc. Article 293 of the Constitution empowers State Governments to give guarantees within such limits, as may be fixed from time-to-time by State Legislature. Although these contingent liabilities are not treated as part of the State liabilities in the existing accounting practices as their occurrence depends on certain future events, given the high level of debt, these are a potential source of fiscal risk. Further, in the case of some of the State guaranteed loans, such as those of irrigation corporations in the States of Gujarat, Karnataka and Maharashtra, the debt servicing directly devolves to the State budget. In all such cases, contingent liabilities are as relevant as direct debts.

In recent years several State governments have been depending more and more on guaranteed loans through State PSUs and SPVs to finance various infrastructure projects. Not many such PSUs and SPVs are in a position to earn enough return from investments to service such loans. There are several instances of defaulted payments. Also, occasionally some States divert such loan funds to fill their current revenue gaps. This breeds fiscal indiscipline. There is an urgent need for curbing this behavior.

As per the available data from RBI (?), the outstanding guarantees extended by 18 major States amounted to about Rs.125,000 crore at the end of March 2001. In terms of GDP, the outstanding guarantees rose from 5.1 percent of GDP at end-March, 2000 to 6.1 percent of GDP at the end of March 2001.

Put Chart III.7 here

It is heartening to note that several States have taken initiatives to place a ceiling on guarantees. Gujarat, Karnataka, Sikkim and West Bengal have put the statutory ceilings on guarantees in place. Rajasthan and Assam have imposed administrative ceilings, for which Tamil Nadu has decided to charge a guarantee commission on outstanding guaranteed amount. (?)

Concluding Observations – Sustainability of Debt:

The above analysis indicates that the combined debt of the State Governments rose phenomenally, recording an average annual growth rate of 16 per cent during the 1990s. As

against this, the gross domestic product at market prices registered an average annual growth rate of 14.3 per cent during the corresponding period. Although the resulting debt/GDP ratio witnessed some decline during the early period of reforms, the trend has reversed since 1997-98, essentially on account of sharp rise in revenue deficits of States during this period. Further, this ratio has started displaying downward inflexibility in the wake of heavy debt servicing burden on the States. The other implications have been declining public investment, crowding out of private savings for current consumption of the State Governments and high real interest rates.

A critical issue that arises is whether the State Governments' mounting interest burden and debt are sustainable at the present level. For their sustainability over medium to long term, an essential condition is that the ratio of debt to GDP does not grow beyond a point. The debt-GDP ratio may, however, remain stable even while there is a primary deficit (i.e. the excess of expenditure excluding interest payments over receipts), as long as the rate of interest does not exceed the rate of GDP growth. This is known as the budget constraint rule. However, the level of primary deficit relative to GDP should not exceed the threshold derived from the difference between growth rate and the effective interest rates on Government borrowings.

Currently, the sustainability condition has been violated in the combined budgets of all States and individually in the budgets of several States. Sustainability condition also suggests that the burgeoning debt burden cannot be serviced indefinitely by creating new debts. Hence, unless the present trends are reversed and the deficits are brought down, the debt-GDP ratio will keep on growing undermining the solvency of the State Governments. From the angle of sustainability, it is, therefore, necessary not only to contain the deficits to levels permissible under the budget constraint rule, but also to bring down the debt/GDP ratio from its present level. The need to contain the debt level also arises from difficulties in debt servicing associated with high levels of indebtedness. When debt-servicing liability is large, as it happens when the level of debt is high and a large chunk of the revenue receipts is used up in servicing the debt, the budget should either cut down non-interest expenditure to the barest minimum or generate adequate revenue to finance the essential expenditure of the Government after meeting the interest liabilities or do both. The higher level of interest payments thus crowd out capital expenditure with adverse implications for output growth. In other words, the present level of State Governments' debt and interest burden is not sustainable in the medium to long-term period.

ANNEX IV

GOI and International Assistance to State Fiscal Management Reform

The Government of India (GOI), Asia Development Bank (ADB), the United Kingdom's Department for International Development (DFID) and the World Bank (WB) have programs in place to support state fiscal reforms. This Annex briefly reviews the GOI and international donor activities in support of state fiscal reform and evaluates the prospects and opportunities for cooperation with USAID.

Government of India

In light of the deteriorating condition of state finances, the GOI has concluded that fiscal reforms at state level has become an urgent component of overall economic reforms. Briefly, the GOI, on the recommendation of the Eleventh Finance Commission (EFC), has established an incentive fund to encourage fiscal correction in the state sector. Each state is expected to take effective steps for revenue augmentation and expenditure compression over the five-year period of this facility, 2000-01 to 2004-05, to broadly achieve the following objectives:

1. Gross fiscal deficit of the states as an aggregate to fall to 2.5 percent of GSDP;
2. Revenue deficit of all states, in an aggregate to drop to zero;
3. Interest payments as a percentage of revenue receipts of the state sector as a whole – 18 to 20 percent;
4. In the Supplementary Report the EFC has also suggested the following objectives:
 - a. Increase in wages and salaries should not exceed 5 percent or the increase in the consumer price index whichever is higher.
 - b. Increase in interest payments (in absolute terms) may be limited to 10 percent per year.
 - c. Explicit subsidies to be brought down by 50 percent over the next five-year period with a view to eliminate subsidies altogether by 2009-10.

Given the broad contours of the fiscal objectives sketched above, the State Governments should draw up a Medium Term Fiscal Restructuring Policy (MTFRP). The Policy needs to dovetail time bound action points such as:

- (A) Fiscal Objectives and Reforms
 - i. widening the tax base;
 - ii. increasing tax rates on a year-by-year basis;
 - iii. pricing services such as irrigation, water charges, bus fares, to an identified base, computing the subsidy element and preparing a schedule to reduce the subsidy element;
 - iv. indexing user-charges to major input costs such as POL, Dearness Allowance, etc.
 - v. abolishing vacant posts in government, except primary school teachers, health workers;
 - vi. new teachers to be appointed on contract basis;

- vii. work charged establishment to be redeployed for new capital works.
 - viii. practice of engaging new work-charge staff and daily-wage workers to be stopped forthwith; and
 - ix. tapering off subventions to G.I.A. Institutions, registration of new Grant-in-Aid institutions in secondary and higher education to be phased out over five years.
- (B) Power Sector Reforms
- i. achieving an average tariff equal to the cost of power within 2 years;
 - ii. setting up of State Regulatory Electricity Commissions (SRECs);
 - iii. implementing the awards of the SRECs;
 - iv. unbundling of basic services – generation, transmission and distribution or setting up separate profit centers;
 - v. reducing T&D losses by 5 percent every year; and
 - vi. metering up to 11 KV sub-station level.
- (C) Public Sector Restructuring
- i. Identify PSEs with a view to determining the need for government to continue as owners;
 - ii. For loss-making PSEs, a comprehensive VRS package to be drawn-up;
 - iii. A time-bound map for winding up such PSEs be laid down;
 - iv. For commercially profitable PSEs, government to decide – either through a high powered committee or otherwise – the extent of dilution in government share holding; and
 - v. Further infusion of government funds either by way of equity or loans to be phased out over 5 years to PSEs, unless such PSEs are identified to be socially desirable.
- (D) Budgetary Reforms
- i. a separate schedule in each state government budget giving the total expenditure on salaries and allowances
 - ii. a separate schedule on pensions and terminal benefit outflows; and
 - iii. a schematic schedule of subsidies (explicit) per sector from the state budget.

Pursuant to the receipts of these guidelines, each state must draw up the Medium Term Fiscal Reforms Program (MTFRP). Release from the incentive fund will be based on a single monitorable fiscal objective. Each state will be expected to achieve a minimum improvement of 5 percent in the revenue deficit as a proportion of their revenue receipt each year until 2004-05. The base-year will be financial year 1999-00.

1. If State 'A' falls short of an improvement of 5 percent in year (t+1) compared to the previous year t, the State will not be eligible to draw upon its share of the Incentive Fund for that year. The amount of the Fund will be carried over to the next year, (t+2);

2. If in year (t+2) State 'A' shows an improvement of over 10 percent compared to the base year 't', the State shall be entitled to its share of the Incentive Fund from the year (t+2) as well as from the withheld portion of year (t+1); and
3. If the improvement in year (t+2) is 6 percent compared to year (t+1) the State shall be eligible for its share for the year (t+2) but not for the year (t+1). The withheld portion of year (t+1) will then be carried over to year (t+3).

Table IV.1 below shows the composition of the Incentive Fund and Table IV.2 shows state-wise goals in terms of revenue deficit as a percentage of revenue receipts.

Asian Development Bank

The Asian Development Bank (ADB) currently is working in three states: Gujarat, Kerala and Madhya Pradesh. The project in Gujarat is winding down; they are currently conducting the final assessment. Madhya Pradesh is mid-way and the project just received permission to release the 2nd tranche. Kerala is just beginning. Meanwhile, projects in Karnataka and UP are under consideration.

The primary form(s) of assistance includes loans with a minor portion dedicated to technical assistance. Under the terms of the loan agreement, for example, Madhya Pradesh is required to implement reforms and develop institutional capacity in the following areas:

- Civil service renewal and anti-corruption strategy;
- Fiscal reform (expenditure management and control, financial management and accountability);
- Public enterprise reform and privatization (creating an enabling environment for private-sector infrastructure, increasing PSE cost recovery); and,
- Tax policy administrative reforms.

Key to these loan program components is that technical assistance is being provided for capacity building for fiscal management reforms. The ADB has established a small policy analysis unit in these two states with limited terms of reference, specifically debt sustainability analysis. The ADB, however, views the need for establishing a state-level analytical policy cell as being an important element to the fiscal restructuring of the state.

As with the WB, ADB thought that USAID could complement their activities. We reviewed the list of technical assistance activities suggested by WB. ADB generally agreed that this would add value to their efforts as well.

(Can you be more specific as to how USAID could complement these activities?)

Table IV.1: Composition of the Incentive Fund
(Rs. in crore)

Year	Withheld portion of the revenue deficit grants	Contribution of the Center	Total Fund
2000-01	1,523.06	598.48	2,121.54
2001-02	1,080.43	1,041.11	2,121.54
2002-03	994.64	1,126.91	2,121.54
2003-04	861.99	1,259.81	2,121.54
2004-05	843.99	1,277.55	2,121.54
Total	5,303.86	5,303.86	10,607.72

Table IV.2: Revenue Deficit as a Percentage of Revenue Receipts (Actual and Projected)

States	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
1. Andhra Pradesh	-15.61	-10.61	-5.61	-0.61	4.39	9.39
2. Arunachal Pradesh	14.77	19.77	24.77	29.77	34.77	39.77
3. Assam	-23.40	-18.40	-13.40	-8.40	-13.40	-8.40
4. Bihar	-28.22	-23.22	-18.22	-13.22	-7.22	-2.22
5. Goa	-18.35	-13.35	-8.35	-3.35	1.65	6.65
6. Gujarat	-19.04	-14.04	-9.04	-4.04	0.96	5.96
7. Haryana	-21.59	-16.59	-11.59	-6.59	-1.59	3.41
8. Himachal Pradesh	-6.66	-1.66	3.34	8.34	13.34	18.34
9. J&K	-2.26	2.74	7.74	12.74	17.74	22.74
10. Karnataka	-12.01	-7.01	-2.01	2.99	7.99	12.99
11. Kerala	-28.40	-23.40	-18.40	-13.40	-8.40	-3.40
12. Madhya Pradesh	-18.95	-13.95	-8.95	-3.95	1.05	6.05
13. Mahaarashtra	-38.86	-33.86	-28.86	-23.86	-18.86	-13.86
14. Manipur	-22.23	-17.23	-12.23	-7.23	-2.23	2.77
15. Maghalaya	-1.35	3.65	8.65	13.65	18.65	23.65
16. Mizoram	-2.49	2.51	7.51	12.51	17.51	22.51
17. Nagaland	-3.17	1.83	6.83	11.83	16.83	21.83
18. Orissa	-33.43	-28.43	-23.43	-18.43	-13.43	-8.43
19. Punjab	-37.03	-32.03	-27.03	-22.03	-17.03	-12.03
20. Rajasthan	-38.58	-33.58	-28.58	-23.58	-18.58	-13.58
21. Sikkim	0.02	5.02	10.02	15.02	10.02	15.02
22. Tamil Nadu	-22.48	-17.48	-12.48	-7.48	-2.48	2.52
23. Tripuna	-9.95	-4.95	0.05	5.05	10.05	15.05
24. Uttrah Pradesh	-34.99	-29.99	-24.99	-19.99	-14.99	-9.99
25. West Bengal	-70.67	-65.67	-60.67	-55.67	-50.67	-45.67
Total	-27.40	-22.40	-17.40	-12.40	-7.40	-2.40

Department for International Development (DFID)

The aim of UK development assistance in India is to work with Indian partners towards Nehru's vision of ending poverty and realizing rights for all. To that end DFID is focusing on promoting five specific objectives:

1. Partnership with selected state governments to tackle poverty more effectively;
2. Accountable government delivering pro-poor reform and growth and effective services;
3. Substantially increased and more effective investment in education, health and water and sanitation;
4. Greater empowerment of the poor, especially women and members of scheduled castes and scheduled tribes; and
5. Better management of the natural and physical environment.

In Andhra Pradesh, Orissa and West Bengal, DFID is seeking to build on already sector-specific dialogue to develop partnership at a strategic level. This will involve developing dialogue – where possible in concert with other donors – on each state's overall development goals and fiscal priorities within this framework for future DFID interventions. As effective partnership develops, DFID will increase the resources deployed in that state and also adopt more flexible forms of financing.

In Orissa, DFID is supporting a new broad-based program of public sector and fiscal reform which, combined with greater investment in education and health, could provide a platform for future partnership. In Andhra Pradesh, the entry point is likely to be that state's strong commitment to reducing poverty through community mobilization as well as DFID involvement in the World Bank's efforts to support reform. In West Bengal, DFID will build on existing sector-based support for the state's strongly poverty-focused programs. DFID will also look to develop closer relations with another poor and reforming state, probably Madhya Pradesh.

DFID is currently working in tandem with/without other donors such as the World Bank in a range of sectors, including public sector and public sector reform in Andhra Pradesh and Orissa. DFID is also working with UNICEF on building joint local government sector capacity in the areas of water and sanitation. DFID's country expenditure commitment profile is defined in Table IV.3, below.

DFID has concentrated its fiscal policy work in the Indian state of Orissa. In Orissa, DFID, and its consultants (Bannock Consultants, Ltd.), has developed a civil service employee database. This database takes into consideration employee numbers, age, date of service and the expected date of retirement. This database should enable the state government more clearly to determine its human resource needs and to quantify its future pension liabilities. DFID also engages in providing technical assistance on public expenditure management, manpower analysis, sales/VAT (tax administration) and public enterprise reform.

Table IV.3: DFID Commitments
(UK Pounds)

Commitments	1999/00	2000/01
Rural Development	12.40	11.30
Environment	0.30	0.20
Economic Reform	7.00	8.30
Energy	20.50	13.00
Water and Sanitation	6.30	5.30
Urban Poverty	9.00	9.00
Education	6.80	8.30
Health	25.00	6.00
Business and Financial Services	2.00	2.00
Others	1.51	2.81
Total Commitments	90.81	66.21

1. Andra Pradesh. DFID involvement is in the general area of government reform, and rural development. They are developing a good government center that involves providing information, reducing corruption, and civil service reform. There is some work underway on privatization (Adam Smith Institute); power sector reform (tariff reform and incorporation) and civil service reform.
2. Madhya Pradesh. The work is just beginning. ADB has given a public finance resource management loan. DFID is providing some TA in financial management. They are working in three areas:
 - Power sector reform. Regulation and tariff reform.
 - Privatization. DFID is working with the state on closure of loss making PSEs and are setting up a unit to continue this work.
 - Community reform to the public (i.e., engaging civil society, holding workshops, trying to enhance transparency and working with the media). They do not even mention the word “deficit” in the media. Media needs help.
3. Orissa. DFID is providing longer term TA on:
 - Budget management, control and manpower.
 - Tax administration
 - Privatization
 - VAT implementation. It is going well, Crown Agents are doing the work.
 - Civil service database development, in oracle, under development. JPS, a Delhi firm, are doing this.

DFID does not see opportunities for collaboration with USAID in the states in which they are presently working in support of fiscal adjustment.

World Bank

The World Bank is India's largest multi-lateral lender. They are currently working in three states: Andhra Pradesh (AP), Karnataka and Uttar Pradesh (UP).

The work in AP is a subnational structural adjustment-type loan. The idea is to promote fiscal sustainability over a 3 to 5 year time horizon. In addition to the normal benefits from positive fiscal balance, they also aim to help client states access other donor funds. They are helping develop medium term fiscal plans.

- **Uttar Pradesh** - The World Bank has assisted the GoUP with a number of technical and financial assistance since the mid-1990s. Early dialogue focused on restructuring the power sector. The WB initiated a structural adjustment credit for US \$251 million in March 2000 to support the first-phase of fiscal and governance reforms initiated by GoUP. Under the terms of the agreement, GoUP is required to implement reforms and build up institutional capacity in the areas of poverty and social impact monitoring, civil service renewal and anti-corruption strategy, expenditure management and control, financial management and accountability, public enterprise reform and privatization, and tax policy administrative reforms.

UP is a more risky state than AP. It is poor, with bad reform credentials. It is in dire fiscal straits; big civil service problems; and a great deal of power sector theft.

- **Karnataka** - The World Bank initiated a structural adjustment credit in the amount of U.S. \$75 million in May 2001. Over the past few years, Karnataka has embarked on a series of fiscal and governance reforms. The Karnataka Economic Restructuring Loan (KERL – 2001) approved by the WB supports GOK's reform program in four primary areas, including: 1) A multi-year framework for fiscal adjustments and reforms to improve fiscal transparency; 2) Tax and expenditure policies; 3) Public expenditure management; and, 4) Financial accountability and accountability and procurement transparency.

The primary objectives of the KERL program are to restore the state's financial health, creating additional fiscal space for high-priority expenditures, and promoting more efficient and transparent management. In addition, KERL's administrative reforms focus on civil service reforms, decentralization, and e-governance with the objective(s) of improving transparency and increasing efficiency. The private sector development component focuses on improving the local business environment through deregulation and privatization (and closure) of public enterprises.

Karnataka historically has not had good reform credentials. The Bank has developed a medium term fiscal plan and this is being institutionalized (partly) with some Australian technical assistance.

In short, WB took a very positive view about the potential for collaboration. They seem to see the Bank and USAID as having different comparative advantages: "We are good at policy

analysis, but not very good at technical assistance.” They already have some collaborative projects with DFID in AP and have worked with the Australians in Karnataka.

They suggested eight areas where USAID could provide assistance that would complement rather than duplicate their work.

1. Civil service reform. They suggested the need for a Human Resources database. This would help the state begin to understand their wage bill and the fiscal implications of various employment and compensation policies. They thought this was especially important for UP, and thought there was already a request for this to USAID.
2. Civil service pension reform. They suggested that the states do not understand the fiscal costs of pensions and have no good forecasts. They could not evaluate the implications of reform options, or even of fiscal decisions. “They are a long way from resolving the pension issue at the state level.”
3. Debt management. The impact of different sources of finance on short- and long-run fiscal position.
4. Implementation of a medium term fiscal framework.
5. VAT implementation.
6. Civil society. Oversight of public operations by the private sector. There are many dimensions to this, such as developing local think tanks; working with “watchdog” groups; media development; surveys of service delivery quality; etc.

Training is needed in state finances. These include, in their opinion, decentralization, general fiscal training of state officials, budget management and policy analysis.

ANNEX V

Decentralization

Until the passage of the 73rd Constitution and the 74th Amendment Act in 1992, the only reference to the Indian Constitution to local government bodies was in the Directive Principles of State Policy. The 73rd Constitution created a new dimension to the federal finance system of India. A third tier of governance below the state level covering the rural sector with a network of institutions of self-government at the village, block/taluka and district levels (referred to as Panchayati Raj Institutions (PRIs)) was for the first time accorded constitutional status. In addition, the roles, rules, responsibilities (both functional and fiscal powers) of PRIs and municipalities were provided some definition. This section of the advisory note provides a brief overview of the decentralization effort in India. More specifically, a brief review of Uttar Pradesh, Karnataka and Jarkhand is given.

Financial and Fiscal Powers of the Panchayats and Municipalities

Setting appropriate expenditure, tax assignment and other revenue-raising powers for each tier of government is a crucial component in any decentralization policy. In theory, decision-making should occur at the lowest level of government. The constitution of India however, does not explicitly lay down any expenditure (functional) responsibility or fiscal powers for Panchayats and Municipalities.

The Constitution provides in the Seventh Schedule, three lists, including: the Union List, a State List, and a Concurrent List. It is from the State List that the legislature of each State is expected to endow the PRIs and Municipalities with sufficient powers to enable them to function as viable institutions of self-government. The 73rd and 74th Constitutional amendments contain two schedules that comprise a list of functions that are considered appropriate for devolution to PRIs and Municipalities. The list of functions is, however, illustrative in nature. The Constitution thus maintains the prerogative of the State in determining the functional (expenditure) responsibilities of the PRIs and the Municipalities.

The Indian Constitution maintains the prerogative of the State legislature(s) to decide which taxes; duties, tolls and fees should be assigned to local bodies and which of them should be shared between the State and local bodies. The Constitution also provides for establishing a finance commission in each State for the purpose of reviewing the financial position of the PRIs and municipalities, and making recommendations to the Governor as to the principles which would govern:

- The distribution between State and PRIs, and that State and Municipalities of the taxes, duties, tolls and fees levied by the state;
- The determination of taxes, duties, tolls and fees which would be assigned (or appropriated) to the PRIs and municipalities;

- The grants-in-aid to the PRIs and Municipalities from each State's Consolidated Fund; and,
- Any other measure that would improve the finances of the Panchayats and Municipalities.

The provision in the Constitution that establishes the Commission(s) envisions a substantial refocusing in State-local fiscal relations. This Constitutional provision also provides the States a unique opportunity to meet the rapidly changing challenges associated with local urban governments. PRIs and municipalities however, do not possess general competence powers permitting them to take actions not explicitly prohibited or assigned elsewhere. PRIs and municipalities possess only legally delegated powers and functions.

Local Governments in a Decentralized Framework

Under the existing federal framework, local governments in India are responsible for a number of functions including: public health (water supply, sewerage, sanitation), public works (maintenance and repair of local roads and works), public safety, education (primary education), and the management of common (public) property. Each state government has its own legislation governing the Panchayats and Municipalities. As a result, local government roles, responsibilities, and functions differ between States.

The 73rd and 74th Constitution envisions a larger role for the Panchayats and Municipalities by providing in the XIth and XIIth Schedules such functions as agriculture (agriculture extension), rural electrification, poverty alleviation, and such functions such as urban planning, urban poverty alleviation, and slum upgrading. Many of these functions have redistributive implications. Notwithstanding, the powers of the State governments in determining the spending responsibilities of the PRIs and the Municipalities continue to be absolute and inviolable.

The tax powers of local governments are subject to the same restrictions as imposed by the State on functional responsibilities. For example, the Madhya Pradesh Panchayat Act stipulates that the State government may assign to a Panchayat such taxes, tolls and fees levied by the State government, and make grants-in-aid from the Consolidated Fund for such purposes, conditions and limits as the State government may deem important. Legislations in many other States have identical provisions (UP, Karnataka). While the actions to determine the functions and fiscal powers are interlinked, in actual practice, such links are at best fragile (if not non-existent). In other words, a change in the spending responsibilities of the local governments is not necessarily accompanied by a corresponding change in the revenue enhancement capabilities of the local government.

Local governments own revenue receipts constitute a small proportion of total government revenues. In 1995, revenue raised by the municipalities formed 4.6 percent of the revenue raised by the Central government and 8.05 percent of the revenues raised by the State

governments.¹ Combined with the estimated revenues of the Panchayats, the local government revenues formed only about one percent of India's gross domestic product. This suggests that with respect to revenue generation, local governments are still a relatively insignificant tier in the government hierarchy.

Local government own revenues are able to meet only a part of their recurrent expenditure. In the case of Panchayats, it is estimated that own-source revenues cover no more than 5-10 percent of PRI expenditures. For municipalities, the average proportion of expenditures covered by own-source revenues ranges between 65-70 percent.²

Transfers From State Governments Are Ad Hoc (Discretionary)

Transfers from State governments to local governments for meeting the revenue gap apparently continue to be ad hoc and discretionary. The absence of predictability and stability in the level of transfers is one of the most significant weaknesses in the existing transfer from State to local governments. In addition, many States have overloaded local municipal governments with tied (specific) grants, which may have had a distortionary impact on local government priorities.

Fiscal Decentralization: The Role of the State Finance Commissions

Articles 243I and 243Y of the Indian Constitution require the State Finance Commissions to examine not only the revenue sharing arrangement between the State governments and local bodies, but the entire body of issues consisting of taxing powers, transfer mechanisms, and even borrowing powers of municipalities. There appears to be little consensus among policy-makers on which taxes should be assigned to which levels(s) of government.

The State Finance Commissions (SFC) has broadly recommended maintenance of the status quo in respect to the tax powers of local bodies. The tax jurisdiction of local bodies largely consists of land revenues, taxes on buildings, taxes on advertisements, and taxes on items such as boats (and animals). A couple of factors appear to have weighed with the SFCs when dealing with local government taxes: 1) Inadequate/inappropriate use of taxes and other assigned duties that are already vested with the PRIs and Urban Local Bodies; and, 2) The sensitivity of other taxes in the State-list to tax rates (and, their unsuitability as local taxes).

The SFCs have however, made suggestions relating to reform of property taxes. Recognizing that taxes on land and property are the cornerstone of municipal revenues, the SFCs of Karnataka and U.P. have called for delinking the annual rateable values from rents, and instead use an area based or site valuation of land and property method. In addition, a number of SFCs have recommend that municipalities and PRIs be granted greater authority in setting the tax rates without making any reference to State governments (e.g. Karnataka).

¹ M.A. Oommen. *Devolution of Resources from the State to the Panchayati Raj Institutions*. Pg. 25.

² Ibid. Pg 26.

The place of local governments (the Panchayats (PRIs) and the Municipalities) is extremely weak in the existing decentralized framework. The following section provides a brief review of some issues with respect to decentralization in the States visited.

Uttar Pradesh

Rural Decentralization: Decentralization, especially in rural areas, is gathering steam throughout India. Beginning with the 2000 Budget, GoUP initiated a far-reaching program of decentralization and devolution of powers and responsibilities to elected local bodies in the countryside (Panchayati Raj Institutions (PRIs)). Significant assets, control of staff, funds and expenditure responsibilities were transferred to the PRIs.³ The PRIs have also been empowered to recruit new staff under their own terms and conditions. The objections of GoUP's program of rural decentralization include: 1) Enhanced beneficiary and stakeholder participation; 2) Improved quality of social services and infrastructure maintenance; and, 3) Increased accountability of rural local government.

The GoUP is committed to financing the full salary expenditures of the transferred staff until the end of 2001. However, from 2001 onwards, the local bodies are expected to finance at least one half of additional wage costs resulting from cost of living adjustments and salary revisions. In addition, all new recruitment by the local bodies is to be financed by the PRIs from their own resources or from devolved resources.

Over the medium term, as the PRIs strengthen their own resource mobilization efforts, support from GoUP is likely to be phased out. The long-term fiscal implications for the state's finances are likely to be positive. However, over the near-to-medium terms, GoUP outlays to support PRIs may actually remain stable, or even increase, as the State may be required to continue to compensate staff that refuses to be transferred to the PRIs.

Jahrkhand

The newly created state is still establishing itself and does not appear to have a clear strategy with respect to decentralization to Urban Local Bodies and PRIs.

Karnataka

India has separate local governments for rural and urban areas. Rules for transfer of resources to both sets of governments are set every five years by the State Finance Commission. Karnataka's second state finance commission is expected to report by the end of 2001. With respect to:

³ GoUP officials estimate that approximately 65,000 regular staff, 230,000 teachers, and about 4 percent of the State's own tax revenues were transferred to rural local bodies – including elementary education, reproductive health and drinking water supply.

Urban Local Governments: Urban local governments are in a stronger financial position than rural governments, but are starved of revenue. The most important source of local government revenue is the property tax. The most important local government reform has been the strengthening of the property tax. Bangalore has recently introduced property tax self-assessment. As a result, property tax revenues in Bangalore have increased by approximately 30 percent.

The GoK currently has plans to make self-assessment possible in all of the state's urban areas. GoK has also announced a funding scheme for all major cities in the states. This new funding scheme was established to provide incentives to urban local governments to improve their financial and operational efficiency.

Rural Decentralization: In the late 1980s, the GoK implemented an ambitious rural decentralization program. A substantial number of staff (including teachers), and a substantial share of public expenditures were transferred to rural local governments, known as Panchayati Raj Institutions (PRIs).

GoK has announced significant initiatives to enhance the autonomy of PRIs. The recent annual budget called for a 75 percent increase in the allocation of untied funds, and important reforms to enhance the tax base of PRIs. Essentially the reforms call for the doubling of land revenue rates and the removal of property tax ceilings. GoK is also taking measures to enhance the effectiveness of PRIs through various computerization and capacity building programs.

Significant issues are still unresolved with respect to the functioning of the Panchayat system, including: concerns that the State level bureaucracy and political establishment exercise a disproportionate role in panchayat governance, that the PRIs have a very limited amount of untied funds, and that the quality of local governance is almost non-existent.

Possible Interactions: The process of decentralization to urban and rural local bodies is expected to evolve and deepen over the near-to-medium term. State officials feel that there is a need for technical assistance for training and capacity building of local urban body and PRI government officials, and for strengthening of financial accounts and local body audit.

ANNEX VI

Three Case Studies

The State Fiscal Assessment Team visited three states: Karnataka, Jharkhand and Uttar Pradesh. These three states were selected because they are thought to represent three types: a slow-reforming state (Uttar Pradesh), fast-reforming state (Karnataka) and newly formed state (Jharkhand). The purpose of this annex is to assess the fiscal condition of these three states and relate their fiscal condition, if possible, to their socio-economic development. In addition, this annex will assess whether these states may be regarded as representative of their respective types. This information is provided in order to help USAID evaluate whether a given intervention is appropriate for a given state type.

A Fast-Reforming State: The Case of Karnataka

In keeping with the general trend in state finances, fiscal developments in Karnataka clearly point towards a steady deterioration. During the last decade while the revenue receipts of the state government on an average have increased at 14.1 percent per year, while the revenue expenditures have shown a higher growth rate of 15.7 percent. In fact the low buoyancy in revenues during the 1990s is seen by the steady decline in the ratio of revenues to Gross State Domestic Product (GSDP) by almost three percentage points from 17.3 percent in 1990-91 to 14.3 percent in 1999-00. In contrast, the share of revenue expenditures in GSDP showed a marginal decline from 17.6 percent to 16.0 percent during the same period.

The fiscal summary of the State government presented in Table VI.1 also shows that the fiscal imbalance is structural; growth of the state's own revenues fell far short of the growth of revenue expenditures. Since the growth of expenditures is outpacing the growth in revenues, naturally this results in a growing revenue deficit from 0.35 percent of GSDP in 1990-91 to 1.72 percent in 1999-00. With the implementation of the recommendations of the Fifth Pay Commission in 1998-99, the fiscal imbalance has deteriorated sharply. Along with the increase in fiscal deficit, the quality of deficit has worsened. While in 1995-96 the entire fiscal deficit was used to finance capital expenditures, in 1998-99 almost one-third of the fiscal deficit was used to finance current expenditures. This is indeed a matter of concern because one of the primary obstacles to growth, according to a survey of businesses in India, is the deteriorating quality of infrastructure.

In addition to the decline in capital expenditure as a share of GSDP, the composition of revenue expenditure is a source of major concern in Karnataka. More specifically, wages and salaries, civil service pensions and interest payments account for over 70 percent of revenue expenditure in Karnataka. Furthermore, the payment of teacher's wages and salaries account for approximately 98 percent of total expenditure on education. The figure for healthcare is over 95 percent. This leaves very little fiscal space for purchases of equipment and medicine in the case of healthcare. Given the important role that medicines and vaccines play in modern health care systems, the productivity of these expenditures is questionable. While Karnataka is at the upper end of the states ranked according to per capita income, it is about average in terms of socio-economic indicators (see Table VI.3).

A Slow-Reforming State: The Case of Uttar Pradesh

In contrast to Karnataka, Uttar Pradesh has shown a sharp deterioration since 1997-98. Total revenue receipts as a share of GSDP has fallen from 12.54 percent in 1990-91 to 10.84 percent in 1999-00, while revenue expenditure remained relatively stable. Accordingly, the revenue deficit as a share of GSDP has grown from 1.95 percent in 1990-91 to 3.73 percent in 1999-00. Likewise, debt outstanding has grown from 24.39 percent of GSDP to 33.48 during the same period. These trends are particularly alarming for a state like Uttar Pradesh because the socio-economic indicators are very low (see Table VI.3). This is reflected in the low per capita income, low female literacy rate and high infant mortality rate. Like Karnataka, the share of state borrowings used to finance deficits in the revenue expenditure budget has grown steadily from 40 percent in 1990-91 to 65 percent in 1999-00.

A Newly Formed State: The Case of Jharkhand

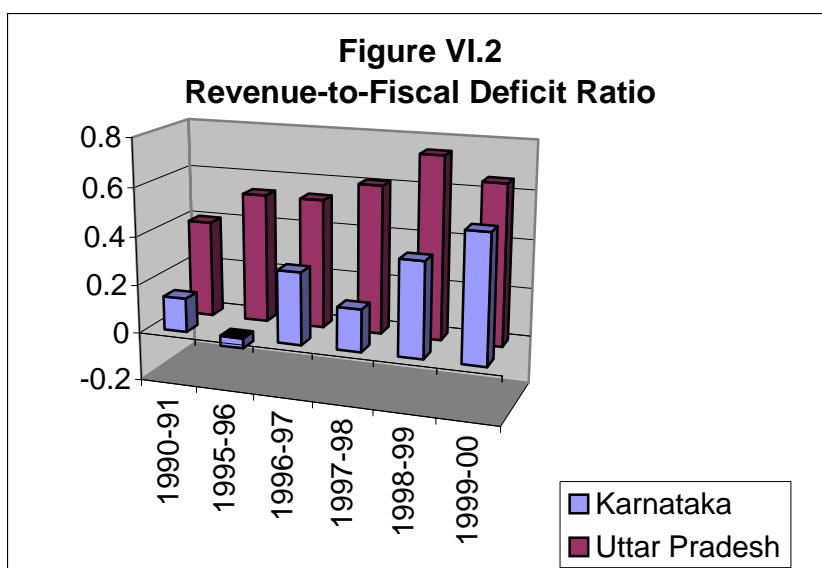
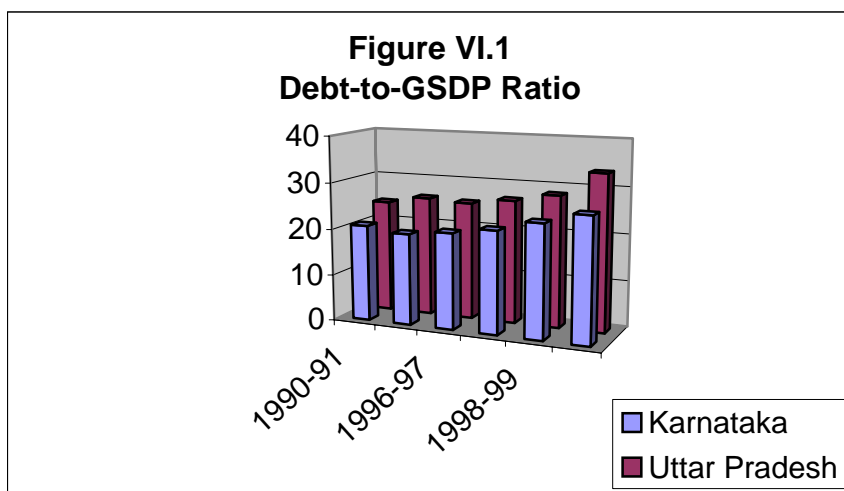
Since Jharkhand is a newly formed state it is not possible to construct a table like VI.1 and VI.2 for Jharkhand. Jharkhand was created by the bifurcation of Bihar. Bihar is widely regarded to be a collapsed state. While the fiscal picture for Bihar may not be as severe as it is for U.P., this is because Bihar simply does not offer many essential services. Although many of the social indicators for Jharkhand are quite poor, the state does enjoy many economic advantages. There are very valuable mineral deposits, particularly coal and iron, and there is a very active steel industry there. Unfortunately, there are high rates of illiteracy and low per capita income despite these advantages. Currently, Jharkhand has a surplus in the revenue expenditure budget principally due to royalty payments from mining of mineral deposits. The challenge for Jharkhand is to avoid the fiscal mistakes of other states and to get good value for public expenditure in order to address the infrastructure backlog and improve social indicators.

Summary

The effect of low growth of revenues and high growth of revenue expenditures has been to create an unstable fiscal situation in the states and to constrain resources needed to finance much needed infrastructure facilities. As shown in Figure VI.1, the debt-to-GDSP ratio has grown in both Karnataka and Uttar Pradesh.

Furthermore, an increasing share of state borrowing are being used to finance unproductive expenditures rather than make needed infrastructure investments that will promote economic growth. This trend is illustrated in Figure VI.2 for Karnataka and Uttar Pradesh by the increasing share of state borrowings that are used to finance revenue expenditure deficits rather than capital expenditures. In other words, the states are borrowing to cover committed expenditures, such as wages and salaries, pensions and interest on state debt, which creates a self-propelling indebtedness as interest payments feedback into larger loans in the next round. Financing revenue expenditures through borrowed funds will not generate revenues required to meet interest payment obligations. This is also true in cases where borrowed funds are used to finance public enterprises with poor financial returns and unproductive capital expenditures. In

all three cases, interest payments add to revenue expenditure proliferation without corresponding revenue generation and leads the state into vicious cycle of indebtedness and interest payments.



By all accounts, the fiscal distress described above has led to deteriorating quality of public services and infrastructure. Despite this deterioration, the states continue to enjoy robust growth rates in per capita incomes and make progress in reducing illiteracy, infant mortality, etc. Although this may be difficult to demonstrate, there are concerns among informed people that the progress during the past decade would have been greater if states had been more financially prudent and state expenditure had been more productive and better targeted. As previously noted, according to a survey of businesses in India, the greatest obstacle to economic growth is the poor state of infrastructure, particularly roads, water supply and treatment and power.

Are Jharkhand, Karnataka and Uttar Pradesh Representative of Their Types?

As previously noted, the State Fiscal Team visited the following three states: Jharkhand, which is a newly formed state; Karnataka, which is a fast-reforming state; and Uttar Pradesh, which is a slow reforming state. The choice of states was intended to reflect the three types: newly formed, fast-reform and slow-reform. The question that arises is whether these states are at all representative of their type.

To address this issue, the team categorized the twenty-five states into these three categories, according to widely held perceptions among Indian observers of state fiscal condition. Table VI.4 shows how the twenty-five states can be categorized along with associated indicators of fiscal distress (Percentage of days in a year that the State Treasury is in overdraft position, ratio of revenue-deficit-to-gross-fiscal-deficit and percentage of total state revenue committed to wages, pensions and interest) and socio-economic development (i.e., infant mortality rate, maternal mortality rate, female literacy and per capita NSDP).

As previously noted, a good indicator of the degree of fiscal distress that a state is experiencing is the percentage of days in a year that the state treasury is in overdraft. Comparing slow-reform and fast-reform states, it is apparent in Table VI.4 that the slow-reform states have a greater percentage of days in overdraft. Furthermore, the ratio of revenue-deficit-to-gross-fiscal-deficit is an indicator of the degree to which states are diverting borrowings to cover recurrent expenditures instead of investing in infrastructure investments. Again, as evident in Table VI.4, the slow-reforming states generally have higher ratios than the fast-reforming states. In other words, slow-reforming states generally are using a greater share of borrowings to cover revenue deficits than fast-reforming states.

In addition, the percentage of total state revenue committed to wages, pensions and interest indicates the quality of revenue expenditure. In many sectors, particularly health, expenditure on wages may not be very productive if it is not matched with significant expenditure on equipment and supplies (diagnostic equipment, vaccines, etc.). Although the data on the share of total state revenue committed to wages, pensions and interest is rather spotty, Table VI.4 is suggestive. It appears that slow-reform states tend to spend a greater share of total state revenue to committed expenditures than fast-reform states.

Finally, it is interesting to see if fiscal distress correlates with indicators of socio-economic development. Table VI.4 clearly shows that infant mortality and maternal mortality tend to be lower in slow-reforming states and per capita NSDP and female literacy tend to be higher in fast-reforming states. Based on these data, it would appear that Uttar Pradesh and Karnataka are representative. The newly formed states require special mention. The Team could not obtain data for the “newly formed states,” therefore they are not included in Table VI.4. In addition, many of the northeastern states are included in the “newly formed state” category. Although the data in Table VI.4 is incomplete, the fiscal distress indicators suggest that they are in relatively good fiscal condition. They are placed in the “newly formed state” category because they generally perceived to lack capacity and to rate low relative to other states in terms of socio-economic capacity.

Table VI.1: Fiscal Profile of Karnataka (Percent of GSDP)

	1990-91	1995-96	1996-97	1997-98	1998-99	1999-00
Total revenue receipts	17.28	17.07	16.43	16.72	14.73	14.29
Own revenue	12.65	13.00	12.14	12.10	11.03	10.37
Own-tax revenue	10.35	10.54	9.85	10.10	9.10	8.92
Own non-tax revenue	2.30	2.47	2.29	1.99	1.93	1.45
Central transfers	4.63	4.06	4.29	4.63	3.69	3.91
Revenue expenditure	17.63	16.94	17.41	17.16	16.32	16.0
General services	5.21	5.33	5.30	5.64	5.41	5.75
Social services	6.83	6.49	6.32	6.52	6.11	5.82
Economic services	5.15	4.89	5.46	4.56	4.37	3.98
Interest payment	1.93	2.09	2.06	2.20	2.12	2.22
Total capital expenditure	2.13	3.03	2.33	2.10	2.49	1.58
Revenue deficit	-0.35	0.12	-0.99	-0.44	-1.59	-1.72
Primary deficit	-0.55	-0.82	-1.26	-0.34	-1.96	-1.07
Fiscal deficit	-2.48	-2.91	-3.32	-2.54	-4.08	-3.29
Outstanding debt	20.74	19.69	20.68	22.01	24.24	26.54

Table VI.2: Fiscal Profile of Uttar Pradesh (Percent of GSDP)

	1990-91	1995-96	1996-97	1997-98	1998-99	1999-00
Total revenue receipts	12.54	12.54	11.52	11.44	9.90	10.84
Own revenue	5.62	6.20	5.36	5.28	5.25	5.66
Own-tax revenue	5.01	4.72	4.63	4.65	4.61	4.83
Own non-tax revenue	0.61	1.48	0.73	0.63	0.64	0.83
Central transfers	6.92	6.35	6.17	6.17	4.65	5.18
Revenue expenditure	14.49	14.56	13.85	14.52	14.96	14.57
General services	4.76	6.44	6.00	6.41	6.59	6.81
Social services	5.15	4.56	4.60	4.91	5.10	4.40
Economic services	3.82	2.76	2.80	2.57	2.56	2.72
Interest payment	2.06	2.87	2.98	3.12	3.21	3.37
Total capital expenditure	3.49	1.89	2.20	2.18	2.15	2.11
Revenue deficit	1.95	2.02	2.33	3.07	5.06	3.73
Primary deficit	2.80	0.91	1.39	1.92	3.56	2.34
Fiscal deficit	4.86	3.78	4.37	5.03	6.77	5.70
Outstanding debt	24.39	25.87	25.41	26.59	28.31	33.48

Table VI.3: Comparative Statistics of India, Uttar Pradesh, Karnataka and Jharkhand

Particulars	India	Uttar Pradesh	Karnataka	Jharkhand
Population (millions)	1,027.0	166.1	52.7	26.9
Share of population (percent age)	100	16.2	5.1	2.6
Rank in terms of population		1	9	13
Annual growth rate of population (percent age)	1.9	2.3	1.6	2.1
Population density (per sq. km.)	324	689	275	338
Density rank		9	20	16
Sex ratio (female per 1000 male)	933	898	964	941
Literacy rate (persons) (percentage)	65.4	57.4	67.0	54.1
Literacy rate male (percentage)	75.9	70.2	76.3	67.9
Literacy rate female (percent age)	54.2	43.0	57.5	39.4
Ranking of States by literacy rate		31	22	33
Crude birth rate	26.5	32.4	22.0	31.1
Crude death rate	8.8	11.0	7.4	9.5
Infant mortality rate	73.5	92.9	55.7	66.5
Maternal mortality	408	707	195	452
Number of districts	593	70	27	18
Per capita income (in Rs)	14,750	9,261	15,889	8,292
Annual Growth of per capita income in real terms	4.5	2.0	5.8	3.0
State's own tax revenue as percentage of GSDP		4.6	7.9	6.5
GFD as percentage of GSDP		6.8	3.5	1.2
Plan expenditure as percentage of GSDP		3.9	4.8	2.2
Capital outlay as percentage of GSDP		1.2	1.7	0.8
Revenue deficit as percentage of GFD		74.8	39.1	Nil
State's own tax revenue as percentage of GFD		68.0	223.1	250.0
Female life expectancy	63.4	61.1	65.4	62.1

**Table VI.4: Statewise Comparisons of Fiscal Distress Indicators
and Socio-Economic Development**

	Percentage of Days Treasury in Overdraft	Ratio of FD-to-GFD	Percentage of Revenue Committed	Infant Mortality 1997	Maternal Mortality 1992	Female Literacy 1991	Per Capita NSDP 1995-96
Slow-Reform States							
Assam	77.75	-26.67		76	544	43.0	6,288
Bihar	22.25	56.77		71	470	22.9	3,524
Jammu & Kashmir	0.00	37.96					
Madhya Pradesh	12.91	69.59		94	711	28.8	6,518
Orissa	53.30	66.21	97.43	96	738	34.7	6,192
Rajasthan	35.16	58.17	94.77	85	550	20.4	6,959
Uttar Pradesh	57.42	74.76		85	624	25.3	5,874
West Bengal	36.81	68.31	152.71	55	389	46.6	8,409
Fast-Reform States							
Andhra Pradesh	40.38	47.04	69.16	63	436	32.7	8,938
Goa	2.75	52.31					
Gujarat	9.34	50.96		62	389	48.6	11,977
Haryana	25.55	68.75		68	436	40.5	13,518
Karnataka	0.00	39.05	63.04	53	450	44.3	9,384
Kerala	56.04	67.39	104.05	12	87	86.2	8,924
Maharashtra	10.16	52.61		47	336	52.3	15,457
Punjab	28.85	69.55		51	369	50.4	16,044
Tamil Nadu	20.88	71.94	85.39	53	376	51.3	10,222
Newly Formed States							
Arunachal Pradesh	0.00	-319.39					
Himachal Pradesh	22.53	61.53					
Manipur	72.25	-101.80					
Meghalaya	0.00	-11.71					
Mizoram	8.79	-33.37					
Nagaland	14.01	5.51					
Sikkim	0.00	37.41					
Tripura	0.00	-78.35					

ANNEX VII

Overview of Management Information Systems in Three States of India

If state government is to be effective in India, and public sector performance is to improve, those charged with providing infrastructure and basic social services must increase the operational effectiveness of state government. Any strategy to improve the operational effectiveness of state government includes the development of management information systems that can be used to monitor and evaluate government programs and assist in decision-making.

Briefly, a proper management information system (MIS) consists of four elements: electronic database; specialized hardware and software to manage the database; a set of routine management reports; and trained staff to maintain the database and produce the management reports. For example, a human resources database would provide centralized information on pay grade, age, years in service, marital status and number and age of dependent children of current employees of the state government. Such a database would serve as a management information system that would allow the Department of Finance, for example, to forecast the aggregate wage bill of the State government for budget purposes as well as monitor and evaluate the budget implications of proposed hiring decisions. Furthermore, it would allow a state to gauge the future pension liabilities of the state.

The lack of appropriate government structures to monitor program effectiveness and support state government decision-making are common problems among the three states that the assessment team visited. The following annex reviews the existing MIS capabilities of these states and their current plans. This review is not exhaustive, rather it is based on impressions gleaned from discussions with state officials. More specifically, we focused on whether the states have a comprehensive human resources database, computerized treasury operations and how these databases are used for management purposes.

Jharkhand

Being a new state, Jharkhand does have a number of positive features working for it, including: 1) Well-established guidelines for budget preparation, including the uniform account codes present throughout India; 2) Approval of the budget by the legislature and senior cabinet ministers before any expenditure can be incurred by the executive; and 3) Preparation of annual financial statements by the State Accountant General and its audit by the all-India Comptroller and Auditor General must be completed annually.

The major shortcomings of the current system include the following: 1) It is labor intensive and does not integrate the accounting, budgeting, and treasury management functions resulting in duplication of records and substantial delays in preparation of periodic financial reports; 2) The current system does not produce the management accounting and cost/expenditure information required for efficient management of the State's resources (and for performance-based management); and, most importantly, 3) The compilation and preparation of financial statements is entrusted to the same agency with responsibility for audit (AG). This

results in the weakening of the accountability framework as the individual departments in the Jharkhand State government have little or no control over their own accounting.

The current financial management system in Jharkhand follows the cash basis of accounting. In times of stress, this most likely will result in the sub-optimal allocation of resources. Overlaying the adverse use of cash basis accounting, is the fact there is no effective internal audit function to support the line departments in ensuring the proper functioning of their internal control systems. A brief illustrative example of the strained conditions present in Jharkhand's treasury operations includes the following: 5 districts are not computerized at all; and, each district apparently operates with a substantial degree of system autonomy (other systems cannot be accessed). This type of system has the potential for creating multiple errors and reducing the State's audit and control functions.

Jharkhand has some of the same gaps as the GoUP. More specifically, they do not have a comprehensive profile of their current employees and they lack current surveys of their major infrastructure investments. Like Uttar Pradesh, Jharkhand also is not fully utilizing available data for management purposes. Although the Jharkhand State government officials intend to upgrade (modernize) and computerize parts of their financial management and control architecture, including internal controls, accounting and MIS systems, there does not appear to be a cohesive integrated rollout schedule.

Karnataka

(to be completed after field visit)

Uttar Pradesh

The GoUP is modernizing and computerizing its financial management and control architecture, including internal controls, accounting and management information systems across the state. As part of this process, GoUP created and filled the new position of financial controller (2000) to provide leadership in modernizing the financial management system.

Having computerized transactions in 70 district treasury offices (over the 2000-01 period), GoUP is continuing to enhance the state's treasury function by converting the treasury offices into Integrated Pay and Accounts Offices. The integrated pay and account offices have been on line and tested since April 2001. Three treasuries have not been computerized. Furthermore, GoUP is replacing the FoxPro database system with an Oracle-based one. At the time of this writing, twenty-two district treasuries have completed this transition. There is a great need for training in order to complete this transition. Meanwhile, data entered into the Oracle system must be re-keyed into the FoxPro database by the headquarters. GoUP plans to make these data available through the Internet. Although these data contain a tremendous amount of detailed information on transactions, it is not being fully exploited to its fullest advantage as a management tool. For example, this system allowed the treasury to detect a number of fraudulent expenditures soon after the fact, which is an improvement over old manual procedures. If,

however, proper controls had been in place, these expenditures could have been stopped before the monies had been disbursed. Remarkably, Jharkhand, in response to a local scam, has developed such controls, but there is no forum for State treasuries to share such experiences and solutions. While a few routine management reports are generated by the treasury system, Department of Finance officials are overwhelmed by the sheer volume of the data. Clearly, there is a great need to train senior government officials to use the treasury system as a management tool to monitor and evaluate government programs rather than simply use it as a convenient data storage and retrieval system.

What has been the immediate-term impact of computerizing the treasury transactions for the GoUP? The former practice of depositing unspent balances at the end of the year into personal ledger accounts (PLA) has been stopped. With the computerization of treasury transactions, relatively integrated systems of reporting time and cost over runs and stricter requirements for new project developments have been established.

The GoUP has a comprehensive list of the names and pay scale of all current class A, B and C employees of the State by department. They do not have such information for all class D employees, approximately 26 percent of the total, and a certain category of teachers. Furthermore, the employee registry is of limited use for simulating future pension liabilities because they do not include information on the number of years in service, age, marital status and number of age of dependent children. Although the state has a comprehensive list of pensioners, they do not have procedures in place to prevent double and triple claims by pensioners or a way to prevent disbursements after the beneficiary's death. Therefore, the civil service pension system is vulnerable to fraudulent claims.

The Departments of Roads, Rural and Urban Development lack current data on existing infrastructure investments. For example, they do not have current surveys and the number, size and condition of schools, number, capacity and condition of major waterworks and the length and condition of the road network. This makes it extremely difficult for Departments to estimate the cost of required infrastructure improvements and establish spending priorities. In addition, they do not collect the necessary information to make empirically based forecasts of operation and maintenance expenditures for existing and planned infrastructure investments rather they use simple rules of thumb, which may or may not be accurate. Given the deteriorating state of infrastructure, one can only conclude that they are not budgeting enough for operation and maintenance of infrastructure.

A cursory review of GoUP tax policy and administrative reforms indicates that the sales tax administration department is also undergoing a rapid computerization program. According to GoUP officials, customized software has been developed for the State. Statewide implementation of computerized registration, assessment, and collection is currently underway.

GoUP is also well underway in establishing a well-defined e-governance capacity. In effect, the State has connected all district headquarters with the State headquarters. The State is also in the process of establishing 10,000 information kiosks. The State IT officer clearly intends to push forward in e-governance in order to provide transparency and illustrative examples of the availability of government services to the community.

In short, while significant MIS advances are underway in isolated cases, specifically treasury operations and e-governance, there does not appear to be a comprehensive MIS strategy to fill existing gaps. In addition, the government does not take full advantage of existing databases. Currently, they are using computer systems as a data storage and retrieval system, in other words as a sophisticated filing cabinet, rather than as a management tool for monitoring and evaluating expenditure programs and assessing future budget priorities.

Recommendations?

ANNEX VIII

An Overview of Subnational Treasury Systems

It is generally accepted that governments must have an agency responsible for its financial management. However, a review of international experiences shows that Treasuries assume a variety of responsibilities within the gamut of functions encompassed by government financial management. In general, the primary mandate of a Treasury is to assure the optimal financial management of government resources, by ensuring that spending agencies are provided, in a timely manner, with the resources needed for a smooth provision of public services, while minimizing the cost of government financing. Treasuries may be established at the center or federal level of government, but in a number of (especially federal) countries, state or regional governments have their own treasuries, independent of the national Treasury.

The development of sound Treasury systems, both at the central (or federal) as well as at the subnational level of government, is seen as an integral part of transparent and accountable good governance practices. As such, multilateral donor agencies and international financial institutions have been lending considerable support to the development of the Treasury function in developing and transition economies around the world. This brief overview relies extensively on the experience of multilateral agencies and international financial institutions in setting up and developing Treasury systems around the world.¹

A Single National Treasury versus Subnational Treasuries

Treasury systems can be broadly categorized into one of two approaches. In the first approach, a single National Treasury is put in place that in addition to providing the treasury function to the central/federal government, also serves the regional (and possibly local) levels of governments. In the second approach, separate and independent treasuries are created for the central/federal government as well as for each regional (state) government. The choice of which approach to follow depend basically on the institutional arrangements for intergovernmental fiscal relations in each country, including, in particular, the degree of autonomy granted to them.

The Single National Treasury Approach. The single Treasury approach (establishment of one national treasury that serves both federal and regional, and possibly local, governments) provides the most comprehensive financial management approach across the public sector, assuring a speedy flow of financial information on government expenditures at each level of government. The development of a single treasury approach would be more beneficial in countries where regional government have limited fiscal autonomy and where operations of different levels of government are highly integrated. At the same time, a single Treasury approach requires a high degree of administrative sophistication and requires a larger degree of central or federal government monitoring and control.

¹ See, for instance: Ali Hashim and Bill Allan. 1999. "Information Systems for Government Fiscal Management." World Bank Sector Studies Series; Barry Potter and Jack Diamond. 2000. "Building Treasury Systems." *Finance and Development* (September): 36-39; Teresa Ter-Minassian, Perdo Parente and Pedro Martinez-Mendez. 1995. "Setting Up a Treasury in Economies in Transition." *IMF Working Paper* ; IMF. 2000. "Setting up Treasuries in the Baltics, Russia, and Other Countries of the Former Soviet Union." Washington: IMF.

In some countries, expenditures by subnational governments account for a large proportion of overall general government expenditure. Therefore, even when it is not legally or politically possible to require these entities to integrate themselves in the government financial information system, it is highly desirable to encourage such integration on a voluntary basis. A single treasury approach would also facilitate easy transfer of funds between different levels of government, including intergovernmental grants.

Obviously, unitary countries are prone to benefit from a National Treasury approach. For instance, in France about 95 percent of subnational expenditures are administered by the national treasury system (*Direction Generale de la Comptabilite Publique*). Many transitional countries (particularly the Central Asian Republics, including Kazakhstan, the Kyrgyz Republic and Turkmenistan) have opted to follow the single treasury approach. Yet, interestingly enough, there are many unitary countries (for instance, Spain and the United Kingdom) and small transitional countries (for example, Latvia and Lithuania) that have opted *not* to include subnational governments in the treasury system.

It should be noted that having a single national treasury does not necessarily preclude subnational fiscal autonomy. The government financial information system can be designed to provide variable levels of budgetary autonomy to any entity linked to it, without losing its main advantage, which is the provision of timely and reliable information on government financial transactions. Therefore, the subnational levels of government could take charge of their own financial programming, set their spending limits, and maintain their financial balances separate from the central government single account, while having their operations processed by the government financial information system.

Subnational (State) Treasuries. An alternative approach to a national treasury is a system in which separate and independent treasuries are created for the federal government as well as for each regional (state) government. While this approach does not provide for an instantaneous flow of information from states to the national level, the system would be more flexible by giving state-level governments responsibility for their treasury systems.

In practical terms, operating a unified treasury across the national territory may be difficult if not impossible in large federal countries, especially where the administrative capacity of the center is relatively weak. However, many developed countries with highly developed fiscal management structures also commonly rely on state-level treasuries. In addition, a system of state treasuries may be more practical and politically desirable in countries where the regional level of government has a substantial amount of fiscal autonomy and administrative independence.

Many of the large, federal countries around the world in fact have independent and separate treasuries at the federal and state levels, including the United States, Canada, and Australia. The role of the federal government over subnational fiscal management activities varies somewhat among this group. For instance, in the United States, the federal and state levels of government work almost totally independent of each other. The federal government does not regulate state financial management systems in any fashion; U.S. federal government oversight and control over state and local government activities is limited to federally funded programs,

where the federal monitoring is specified as a condition of the funding. In contrast, while states and territories in Australia's Commonwealth have their own, independent treasury operations, certain limits on subnational borrowing are imposed and monitored by the Commonwealth Treasury.

In many large, developing and transition countries, allowing states to create and operate their own treasury systems should be considered a practical and viable alternative to the often administratively more cumbersome and politically more objectionable establishment of a single national treasury. Reliance on state-level treasuries allows for greater fiscal autonomy at the subnational level, ensures greater state-level monitoring, and often allows for greater state level control over its own financial resources. At the same time, federal control over key macroeconomic policy areas such as public sector debt management is not impeded by a system of separate and independent treasuries. When state treasuries are given proper technical resources, assistance and central guidance on administrative standards, the existence of independent state treasuries (vis-à-vis a single national treasury) should do little to impede the flow of fiscal information. In fact, by giving states a larger stake and increased control over their own financial management systems, independent treasuries may actually be able to provide faster and more reliable information on subnational fiscal transactions than a single, centralized agency.

Dimensions of Government Financial Management

Whether at the central government level or at the subnational government level, the Treasury plays a central role in the execution of the government budget, although the exact role of the Treasury differs from case to case. However, in performing its tasks, the Treasury almost universally has to work together with a number of other government organizations, including other offices within the Department (or Ministry) of Finance, such as the Budget Department, the Accounting Office, as well as line departments (ministries) and spending agencies. The Treasury's participation in budget execution can vary from a passive one (when the Treasury does not intervene directly in the execution of the budget, but merely makes the resources available to spending agencies to execute their programs) to a fully active one (when the Treasury is empowered to set limits on commitments or payments of government expenditures, or even to authorize specific expenditures on the basis of pre-established criteria).

The main functions of budgetary and financial management of government operations that directly relate to the operation of the Treasury include:

- formulation of budgetary and tax policies;
- budget preparation;
- budget execution;
- accounting and financial information systems;
- auditing and evaluation.

In many cases, the Department or Ministry of Finance is primarily responsible for all the above areas. In others, one or more of these functions are assigned to other entities. There are

several other functions, of an administrative and regulatory nature, which are also carried out by Ministries of Finance. Among these are the preparation of financial legislation, monitoring and control of non-bank financial intermediaries, financial monitoring and control of state-owned enterprises, and the regulation of wages and conditions of service of government employees.

The functions of the Treasury within the Ministry of Finance vary significantly from one country to another, and from one state to another, reflecting each country's specific historical, institutional, and political circumstances. However, cash management is a Treasury's most basic and fundamental responsibility. At a minimum, the Treasury must secure complete, timely, and accurate information, and must exercise adequate control on all the inflows and outflows in government's accounts. These include not only budgetary revenues and expenditures, but also extrabudgetary inflows and outflows, e.g. those which the government's spending units execute on behalf of third parties, such as international aid flows.

A global trend with regard to the development of the treasury function in developing and transition countries is one in which the Treasury, as the central financial management arm of the government, holds what is customarily called a single account. In summary, the single account is an overall account held by the Treasury, in which all government operations are recorded, and in which government funds are held (except for any Treasury placement accounts in the banking system). Under this arrangement, no spending unit is allowed to hold individual accounts either in the banking system, except in the cases referred to below. The spending units' accounts in the banking system are replaced by accounts in the government financial information system, as explained below. The establishment of a single treasury account need not imply less autonomy for the ministries and spending agencies in the use of their idle balances, provided that they are used in accordance with the established budget and financial limits and procedures, and, of course, it helps reduce the financing requirements of the government, and consequently the interest charges to the budget.

Specifically, the working of the single account can be summarized as follows:

- a government financial information system (GFIS) is set up, which includes ledger accounts for ministries and the other spending units. This system registers each movement in these accounts (inflows and outflows), and the balance in each account represents effective capacity to pay, up to the balance;
- each spending unit can keep one or more accounts in the GFIS, depending on the degree of detailed control that is desired. In general, cash spending limits are set, registered in the system, and controlled at a more aggregate level than those used in the budget process;
- all public revenues (those accruing to the state budget, as well as the own revenues of autonomous agencies and extrabudgetary funds) must be deposited in the single account, but would also be credited simultaneously to the appropriate account in the GFIS;

- transfers between spending units must be registered in the GFIS, but do not affect the single account;
- only payments to entities outside the system (e.g., government suppliers, public employees, holders of government debt, taxpayers entitled to refunds) are debited to the single account.

It should be stressed that the financial consolidation of government balances is perfectly compatible with the continuation of a decentralized execution of the budgets of spending units. The Treasury ensures an orderly flow of transfers from the state budget to the other agencies, and acts as a de facto bank for them.

Therefore, for the ministries and other spending units, there is little, if any, difference between the functioning of a banking account and of a financial limit account in the GFIS. As a matter of fact, these entities benefit from the availability of reliable and timely information on their accounts provided by the GFIS.

Spending units should be allowed to have their own accounts in the banking system in the following cases only:

- when the Treasury system does not have the technical capability to maintain and control the individual financial limits of spending units. In this case, spending units would keep their own accounts as subaccounts of the single Treasury account. The nature of subaccounts is important because it indicates that, although these resources are available to the spending units, they belong to the single account;
- for spending units located in places that are difficult to reach. These agencies could have accounts with the central bank, in the banking system or, in extreme cases, could keep cash resources. They would operate using the system of advances, whereby an advance would only be granted after proving that the previous advance was used. In general, these spending units are relatively small, and account for a very small portion of public expenditures.

Basic Organization and Structure of the Treasury

Many developing and transition economies are characterized by a difficult economic situation, fraught with fiscal uncertainties. These conditions call for a system of government financial management that allows a quick and effective response of budgetary policy to changes in the economic environment, so as to minimize macroeconomic instability. To assure this speed in adjustment, and the necessary coordination between budgetary and financial operations, a high degree of institutional concentration of these core functions is recommended. It is preferable that for each (semi-)autonomous government unit, a single agency (i.e., the Treasury) is responsible for most of the government's financial management functions. The basic organization and operation of a State Treasury is, for virtually all intents and purposes, the same as a national Treasury. One of the main operational differences is that while National Treasuries typically

hold their Single Treasury Account with the Central Bank, a commercial bank is typically used for this purpose by state level banks.

A concentration of financial management functions allows the system to be more easily computerized, which in turn speeds up the flow of information. It is this access to timely information on budget execution and financial flows that allows the Treasury system to increase budgetary control, to plan and effect rapid adjustments in the execution of the budget, as required by changing economic circumstances, and to be more efficient in the cash management of government funds. If one or more of the typical Treasury functions are excluded from its responsibilities in a particular country, the structure and operations of the Treasury need, of course, to be adjusted accordingly.

In relatively large countries or states, it is advisable to set up the Treasury with a two-tier structure: a central one, including a number of departments and/or divisions responsible for the main Treasury functions; and a network of regional offices, responsible for the operations of the Treasury in the respective regions. For the effective functioning of the Treasury, it is crucial that the regional offices be entirely subordinate to the central Treasury, without any formal links to the local administrations. Cooperation with the latter should be viewed as a service to them, rather than a joint subordination.

It should be stressed that there is no unique model for the organizational structure of the Treasury. The number and specific functions of its divisions and offices has to be determined on a case-by-case basis, in the light of the specific needs of each country, and each one is likely to evolve over time as the Treasury develops. For illustrative purposes, Table VIII-1 presents one possible configuration of the Treasury's central organization, based on the key functions envisaged for the Treasury.

In larger countries or states, regional Treasury offices would perform the following functions:

- process - through the government financial information system - the expenditures of spending units not directly linked to the system;
- at the end of each business day, authorize the regional branch of the central bank to carry out the payments registered into the system by the spending units directly linked to it;
- ensure the timely and accurate transfer to the government account of revenues collected by other agencies (e.g., taxes collected by the commercial banks), and register these operations into the government financial information system; and
- perform control and auditing functions with respect to the spending units in its region.

Table VIII-1: Possible Organization Of Treasury Functions

Function/ Organization Unit	Task of Organizational Unit
Analysis and Financial Planning	
Monitoring & Operational Analysis Unit	<ul style="list-style-type: none"> On basis of accounting information generated by the system, prepare analyses and reports on government operations
Financial Planning Unit	<ul style="list-style-type: none"> In consultation with other units within and outside the MOF, prepare forecasts of cash inflows and outflows for Treasury, and determined monthly spending limits
Budget Execution	
Budgetary Operations Unit	<ul style="list-style-type: none"> In consultation with Budget Dept., distribute overall cash limits among ministries; monitor crediting of receipts to Treasury Single Account
Special Funds Unit	<ul style="list-style-type: none"> Monitor operations of extrabudgetary funds, and manage the flow between them and the budget
Subnational Government Unit	<ul style="list-style-type: none"> Monitor operations of the subnational government levels
Debt/Asset Management	
Internal Debt Unit	<ul style="list-style-type: none"> Maintain register of, and manage, domestic debt and debt service, including operations with the Central Bank. Monitor domestic contingent liabilities
External Debt and Aid Unit	<ul style="list-style-type: none"> Maintain register of external debt and debt guarantees; manage service of debt; monitor foreign aid flows
Asset Management Unit	<ul style="list-style-type: none"> Maintain asset register, deal with financial aspects of privatization
Accounting	
Accounting Methodology Unit	<ul style="list-style-type: none"> Set standards for and regulate government accounting, including accounting plan and schemes
Accounting Operations Unit	<ul style="list-style-type: none"> Process budget accounts; undertake accounting operations which are not automatically executed by the system; prepare official accounting and periodic reports
Audit	
Audit Unit	<ul style="list-style-type: none"> Monitor correctness of use of public funds within the Treasury system; organize specific audit investigations
System Management	
System Management Unit	<ul style="list-style-type: none"> Manage computerization and Treasury systems development; organize related training

Clearly, financial planning involves a complex network of information flows between various units responsible for the management of government revenues and expenditures. Some of these units are typically located within the Treasury, some in other parts of the Ministry of Finance and some in other government agencies (notably spending ministries, the tax administration and the central bank). As a consequence, it is important that the Treasury include a unit responsible for coordinating the whole process of financial planning, drawing on these information flows as appropriate. A sample financial planning sequence, including the planning tasks and agencies involves, is reflected in Table VIII-2.

Table VIII-2: Financial Planning Sequence, Tasks And Agencies Involved

Tasks	Agencies Involved
Step 1 –Setting Up the System	
Defining the horizon and frequency of financial planning	Treasury
Setting up the channels of information	Treasury
Step 2 – Preparing the Financial Plan	
Agencies forward information based on these specifications	Treasury, Budget Department, Central Tax Administration, extrabudgetary funds, Central Bank and ministries
Calculate total inflows and outflows	Treasury
Discuss possibilities for adjustment in various items which comprise financial planning (including the volume of gross borrowing required and available finance options)	Treasury, Budget Department, Central Tax Administration, Central Bank
Prepare final financial plan	Treasury
Define monthly or quarterly limits on commitments and payments (optional)	Treasury or Budget Department
Step 3 – Execute and Monitor the Financial Plan	
Inform ministries of respective limits on commitments and payments	Treasury or Budget Department
Monitor inflows and outflows	Treasury
Manage financing of deficit in accordance with approved financial plan, in cooperation with the Central Bank	Treasury and Central Bank
Step 4 – Update the Financial Plan	
Analyze and investigate deviations from plan	Treasury
Recommend appropriate corrective steps	Treasury, Budget Department, Central Tax Administration, Central Bank

The Treasury's Relationship with Other Entities

Obviously, federal (or central) governments and state governments require rapid and accurate information on the operations of those parts of the public sector that they control. However, they also require similar information on the payments and revenues of other public entities, including lower levels of government, in order to be able to anticipate any implications of developments in those entities for their own budgets, and in order to manage effectively their overall budgetary policy.

This monitoring can be performed in two different ways: by receiving periodic reports from those entities, or by incorporating them into the government financial information system. In the first case, it is necessary to develop and implement a set of rules and forms based on standardized accounting practices, so as to permit an accurate consolidation of the information

received. The effectiveness of this system depends upon the willingness of each entity to send the information, its accuracy, and the resources available in the Treasury to process them. Therefore, this system is time-consuming and subject to delays and inconsistencies.

By contrast, the incorporation of these entities into the government financial information system entails considerable benefits, without necessary reduction in the legal autonomy of each institution. First, information flows about developments in the finances of these entities become more readily available both to them and to the Ministry of Finance. Second, the standardization of accounting practices across all levels of government, the implementation of similar expenditure authorization and control processes, as well as similar methods of financial planning, all tend to facilitate the financial management of the entire public sector. In addition it should be noted that this incorporation need not imply any loss of individual accounting information about the different institutions and levels of government involved, since their accounts can be maintained separately in the system.

Extrabudgetary funds and other autonomous public agencies. Quite often, different types of decentralized entities are set up to perform typical government functions. This strategy aims at: (1) giving these entities a greater degree of managerial autonomy which, theoretically, would allow them to better fulfill the purpose for which they were established; and (2) earmarking public revenues to the operations carried out by them. These entities may have their own legal personality, or may just constitute accounting funds, generally known as extrabudgetary funds. Frequently, these funds are part of a social security system, such as pension, employment, health funds, etc.

As these funds perform typical government operations, and these generally involve considerable sums- -often comparable to the general government budget- - it is crucial for the economic authorities to have complete and up-to-date information on their financial performance. The lack of such information can significantly jeopardize the effectiveness of the central government's fiscal adjustment efforts. For these reasons, the general procedures for budget execution should also apply to the operations of extrabudgetary funds, and their operations should be processed through the government financial information system.

Public enterprises. For the purpose of this overview, public enterprises must be divided into three groups. The first would include those enterprises that, although constituted as companies, perform typical government functions. In this case, the procedures discussed above for extrabudgetary funds would be applied.

The second and third groups include entities engaged in commercial or industrial activities. In this case, the relations of these entities with the Treasury should take into account primarily their degree of dependence on government contributions, in both absolute and relative terms. The second group covers enterprises that rely heavily on these contributions. From the standpoint of the government finances, it is important that the Treasury has close and effective control over the finances of these enterprises through their linkage to the government financial information system.

The third group includes the enterprises that are marginally, or not at all, dependent on transfers from the central government. In this case, the Treasury's relationship with these enterprises would typically be that of a controlling shareholder, including, inter alia, examination of the enterprises' financial statements, monitoring of their economic and financial situation, participation in their Boards of Directors, and attendance at their general shareholders' assembly.

The Treasury's Relationship with the Central Bank

At the national level, Treasury functions would be very difficult, even impossible, to perform without the cooperation of the Central Bank. This cooperation (summarized under the notion that the Central Bank should be the "fiscal agent" of the National Treasury) includes, a vast range of functions, hinging on two factors: 1) the critical position of the Central Bank in relation to the payments system; and 2) the responsibilities of the Central Bank concerning monetary policy.

In a modern economy, payments take place largely through transfers to and from bank deposits. These imply ultimately transfers among financial institutions of their deposits with the Central Bank. As the National Treasury is likely to receive payments from, and make payments to, a very wide array of economic agents in the country, holding the single Treasury account at the core of the payments system is the best means to minimize the number and volume of transfers of funds, and the attendant gross flows of information.

As a result, taxes are collected through the banking system, which in turn transfers the proceeds to the single Treasury account with the Central Bank. Similarly, budgetary payments are carried out by issuing orders to the Central Bank to transfer global amounts of funds, to specific financial institutions, which in turn, are requested to pay to individual deposit holders. In the case of financial transactions, the payment functions of the Central Bank and the financial institutions are even more direct, as banks themselves are most likely to be the holders of government debt, or to act as depositories for its final holders.

In contrast to national treasuries, state treasuries often do not keep their treasury accounts with the Central Bank. Instead, the administration of a state's treasury accounts is frequently outsourced to a commercial bank. The financial services for administering the state's treasury accounts are typically procured through an open, competitive bidding process. Subcontracting the treasury system's administration to a private financial institution is a practical way for many subnational governments to access the necessary financial management expertise without having to build such capacity from scratch.

Where are the Controls in a Treasury System?

In addition to the usual cash management activities assigned to Treasuries, in some countries and states the Treasury is assigned the overall responsibility for budget execution and control at the central level. (In other cases these activities are assigned to other government departments, for example Budget Department or the Government Accounting Office.) When this responsibility is assigned to the Treasury, it would require the Treasury to exercise control over

execution of one or more stages of the expenditure process, i.e., commitment, verification, and payment. Specifically, these stages can be summarized as follows:

- *Commitment stage:* the commitment constitutes the destination (and, as a consequence, the setting aside) of part of the budget allocations for a specific expenditure, in accordance with the approved budget. Generally, it takes a form of contracts with suppliers of goods and services. It is essential to record the commitment stage for two main reasons: to control the actual availability of budgetary resources for assuming new obligations, and to monitor the newly created obligations and their impact on the projected cash outflows from the single account.
- *Verification stage:* in the verification stage, a spending unit verifies and certifies that all requirements for payment of a particular expenditure have been met (e.g. the good has been delivered or the service performed as contracted, an interest payment or loan redemption is due). Registering this step enables the Treasury to track liabilities incurred but as yet unpaid, and to know immediate resource needs for payment.
- *Payment stage:* this is the stage at which the obligation incurred above is paid, thereby reducing the government's liabilities.

Treasury operations in the control of budget execution may take different forms. In some cases, the Treasury sets and controls overall financial limits for the commitment and payment stages. In other cases, the Treasury reviews and approves each individual expenditure item to be committed and/or paid. Finally, there are cases in which the Treasury simply disburses the payment orders issued by the spending units, without participating in the previous stages. The appropriate *modus operandi* in this respect needs to reflect the economic conditions and historical, cultural, and political factors specific to each country.

Two Approaches to Setting Up a Treasury System

It may be helpful to distinguish two broad approaches to, or generic models of, technical assistance delivery in setting up a Treasury system. Again, little distinction needs to be made when considering setting up a Treasury at the national level versus setting up state-level Treasury agencies.

The first approach might be termed the high-tech approach, in which the technical assistance provider aims to directly develop the four main elements of the treasury system: a treasury payments capacity, the Treasury Single Account, a Treasury General Ledger system, and a financial planning component. This could be achieved by creating an integrated computerized payment, accounting, and Government Financial Management Information System, covering (initially) all federal or central government transactions within a powerful, centralized treasury. The key elements of this approach are centralization and integrated computerization. Under this approach, however, the first step should be to develop an interim computerized system for processing payments that lacked the full accounting and information regime, and the financial planning facility, of the final integrated network.

The high-tech approach has its roots in the 1992 Brazilian system. This system, developed over a very short period beginning in 1986, was considered state of the art for a developing economy in the early 1990s. The Brazilian system was based on a single integrated computerized accounting and information system, which:

- centralized and processed all payments (both federal government and state) through the treasury;
- held all government financial resources in a single account at the central bank;
- prepared the full accounting records (receipts and payments) of government; and
- included the necessary modules for sophisticated budget execution and spending control (through commitment monitoring, automated stop payments, etc.), a fiscal information and reporting system, and even a budget preparation system.

The second approach, which is more gradualist, is often applied in smaller countries. This approach aims to achieve the interim computerized system under the high-tech approach. The initial stage of development involves the establishment of a manual (or very limited, “stand-alone” computerized) approach to payment processing through regional treasuries, working as part of the finance ministry.

Under this more “decentralized” approach, the treasury is initially set up to function essentially as a regionalized payment-processing agency. But this has to be accompanied by the creation of a single bank account, and the setting up of basic government accounts for cash transactions at the regional treasury offices for each line ministry and spending agency. The more important central tasks of the treasury, such as stronger budget execution controls and better financial planning, have to be put on hold until the development of greater financial management expertise and a more sophisticated accounting regime. The gradualist approach also envisages the eventual development of integrated computer systems, rather than separate stand-alone computer systems, which often vary across regions within a country.

What factors influence the choice of one approach to the development of a Treasury system over the other? Several factors play a role in this decision. The first factor that determines the speed of the reform and development of the treasury function is the complexity of the current government financial management system. It will be easier to achieve a more complex treasury system if the current financial management system is already relatively sophisticated. A second factor is the size of the country or state; obviously a large financial management system server for a large geographical area will be harder to upgrade and manage. A third determinant is the capacity of the Ministry of Finance and the Treasury to upgrade its human resources capabilities. In addition, the capability of other users of the system (such as finance officials in line ministries and spending agencies) to absorb the reforms and upgrade their human resources is important as well. A fourth factor that helps determine the speed of Treasury reform is the amount of resources available for the computerization of the system and training of staff. The availability of large internal or external resources for training and computerization would obviously put a country in a better position to allocate resources to a treasury reform project.

ANNEX IX

The Fiscal Planning and Analysis Cell

None of the three states visited has a cell within the Department of Finance dedicated to fiscal planning and fiscal impact analysis. Yet almost all Indian states find themselves in positions of fiscal uncertainty, all are facing significant deficits, and all have indicated the need for better fiscal planning. Among the substantive areas that call out for hard policy analysis are the impacts of power sector reform, the operations and maintenance costs of increased capital spending, the implications of the target deficit reduction mandated by the center, inadequate fiscal effort, decentralization strategies, and the expected future costs of debt servicing. These are only a few examples of big fiscal issues that will face states in the immediate future.

Not only must the states have a better facility for policy analysis and forecasting in order to better manage their development, but the donors and the central government will require it to insure compliance with loan agreements and with central government mandates. In particular, the new GOI facility for State fiscal relief lays down a menu of required reforms that must be supported by hard analytic work. However, none of the donors visited in the course of this mission has undertaken to support the development of fiscal analysis units at the State level.

What is a Fiscal Analysis Unit?

A fiscal analysis unit (FAU) within the Department of Finance can serve as the principal policy analysis agent of the state government on matters related to the budget. Properly constituted, it would have the following budget characteristics:

- significant expertise in areas related to fiscal analysis.
- develop and maintain databases that would support hard fiscal analysis.
- be focused on fiscal impacts and projections.
- be a permanent body, so it could have “memory” and would continuously build on its policy research base.
- be relied on heavily by the state government.
- regular duties as well as special assignment duties.

Goals and Objectives

The ultimate goal of setting up a fiscal analysis unit is to assist the government in making more informed fiscal policy decisions. Now is a time when Indian state government deficits are very high, and there is no reason to expect that external events (a higher rate of growth or lower rate of inflation) will bring them down. Deficit reduction and long-term state fiscal balance will only be realized as a result of sweeping policy reforms. There is now a very high premium on good fiscal planning.

The FAU would achieve its goal in two ways: First, it would make fiscal analysis more transparent by carrying out special analyses of major issues. It could remove some of the

guesswork from fiscal choices, and the consequences of fiscal policy choices could be more clearly identified. Politicians, government officials and civil society could gain a better understanding of the hard costs and benefits of various fiscal options.

Second, it could institutionalize a more forward-looking approach to fiscal planning. Instead of taking only an annual budget planning view, the FAU could also draw attention to the longer-term consequences of any action by factoring this calculation directly into the analysis and projections. Especially in India, the long-term consequences of state fiscal actions (pensions, debt guarantees, direct debt) are of great importance.

Another objective of the FAU is to upgrade the policy analytic capacity of the state government. The FAU would focus on fiscal analysis, but it would also reach out to various sectors (e.g., health, power, education) in some of this work. A demonstration of the utility of policy analysis might ratchet up enthusiasm for analytic work, and open new opportunities and demands for training.

Activities of the Fiscal Analysis Unit

The FAU will not be successful if it is no more than a Finance Department Research Institute. It must have a set of regular and important responsibilities, so that it can be an integral part of State Fiscal Planning. The full range of responsibilities would have to be worked out with the State Finance Department, so as to fit in with the present organizational structure and responsibilities, but the following list of responsibilities is illustrative of what a successful FAU might do.

- *Responsibility for the annual forecast of budget revenues, and expenditures, and for maintaining a three-year rolling forecast.* This would be done with some sort of modeling approach. Each year, the FAU would be charged with developing and reporting a forecast of the expected deficit, and the structure of the deficit. This information would be the basis of the Department Secretary's fiscal plan for the year and for the future.
- *The preparation of fiscal notes.* A fiscal note is an analysis or brief, relating to a particular proposal. For example, a new capital project may involve new debt service and new O&M costs, and the short and long run fiscal impact of these would have to be estimated. The FAU could be responsible for preparing fiscal notes, at the request of the Secretary, on all major decisions that would have a significant fiscal impact. This would not replace the work of the budget analysts, but it would give responsibility for the larger and more complicated issues to the FAU.
- *Special studies of fiscal impact.* There are many areas where the issues related to fiscal impact are complicated and the policy choices are not easily costed out. In such cases a special study is required. For example, the impact of loan guarantees, whether a federal proposal will actually reduce the demand for loan guarantees, the revenue implications of a new user charge, or of a particular change in VAT

administration, etc. In these cases, at the request of the Secretary, the FAU would either carry out the study or oversee the work done by a contractor.

- *The FAU could assist the Secretary in matters of compliance with GOI mandates (the new donor facility) or with international agencies.* The FAU could be charged with doing a tracking of the performance of the fiscal sector, for compliance purposes.
- *Responsibility for liaison concerning certain databases could rest with FAU.* When government develops a database that is needed for evaluation or fiscal planning, the FAU could be involved in its design and update, and would be a user of the data for analytic purposes.

Organization and Staffing

The FAU should be located within the Department of Finance, with duties approximately as outlined above. The unit should have no other duties than fiscal analysis. It cannot be effective if it is a “part-time” analytic body.

Given the amount of work to do, and the precarious nature of state finances, an initial size of a Director plus 4-6 analysts would be appropriate. The analysts should have backgrounds in economics or public finance or a related field. A program of training will be required, and some foreign training would be highly desirable. Given the usual attrition that occurs with new institutions and training, a somewhat larger initial staff might be considered.

The staff composition might look as follows:

Director: A senior public finance/policy analysis expert perhaps seconded from another agency within or outside the state. This should be a person with skill in analytic public finance work, and in modeling.

Senior Analysts: 4 to 6 analysts with backgrounds in public finance or a related area. They should be analytic-oriented, with some background in quantitative analysis. Possibly one or two could be people with background in financial analysis, to handle the public enterprise and debt issues.

MIS person: Someone capable of developing and maintaining a database or maintaining a relationship with another department that has a database that will be used by the fiscal analysis unit.

Some provision will need to be made for training. The analysts will need training in public finance analysis, particularly forecasting, impact analysis, and basic techniques in tax policy analysis, expenditure analysis, debt management and intergovernmental fiscal relations. Foreign training would be ideal, with follow-up refresher and career courses, offered perhaps by an Indian training institute.

ANNEX X
List of Interviews

I. NEW DELHI

Department of Economic Affairs, Ministry of Finance (DEA, MOF)

Ashok Lavasa, Joint Secretary, AC/ADB (011-3012387)

Sharmila Chavaly, Director, AC/ADB (011-3014420)

R. Setia, Secretary (011-301....)

Ministry of Finance (MOF)

R. Bannerjee, Joint Secretary, State Finances (011-3014811)

Rakesh Mohan, Adviser to Finance Minister (011-3014818)

Eleventh Finance Commission

Amaresh Bagchi, Member, 11th Finance Commission (011-6569780)

National Institute of Public Finance and Policy (NIPFP)

Ashok Lahiri, Director (011-6569780)

Om Prakash Mathur, Professor (011-6568303)

D.K. Srivastava, Senior Fellow (011-6568303)

M.C. Purohit, Professor (011-6568303)

Tapas Sen, Senior Fellow (011-6568303)

National Council of Applied Economic Research (NCAER)

Suman K. Berry, Director General (011-3370466)

Shashank Bhide, Chief Economist (011-3317860)

Rajesh Chaddha, Economic Advisor (011-3379861)

World Bank (WB)

Steven Howes, Senior Economist/Team Leader Fiscal-Karnataka (011-4617241)

Sanjay Pradhan, Senior Public Sector Management Specialist-U.P.& A.P. (011-4617241)

Manuella Fierro, Poverty Reduction and Economic Management/Team Leader-U.P.
(202-473-8290)

Ravi Shankar, Senior Economist/Joint Team Leader-U.P. (011-4617241)

Vikram Chand, Senior Public Sector Management Specialist (011-4617241 ext. 257)

Asian Development Bank (ADB)

Frank J. Poleman, Country Resident Representative (011-4692578)

Thevakumar Khandhya, Senior Investment Officer/Programs Officer
(011-4692578)

Hiranya Mukhopadhyaya, Economist (011-4692578)

British Department for International Development (DFID)

John Burton, Senior Economic Adviser (011-6529123)

Manju Senapathi, Economic Advisor West Bengal Team (011-6529123)
Sangamitra, Economic Adviser Orissa Team (011-6529123)

II. UTTAR PRADESH (U.P.)

Department of Externally Aided Projects

Rohit Nandan, Secretary (0522-238942/9839080862)

Department of Finance

B.K. Mittal, Principal Secretary (05222-434238)

Joshi, Secretary

Sanjeev Ahluwalia, Secretary

Mishra, Secretary

Fiscal Statistics, Department of Finance

B.B. Singh, Director

Department of Planning

S.N. Jha, Principal Secretary (and staff)

De-Regulation Committee, Administrative Reforms Department and Expenditure & Resources Commission

Vijay Krishna, Chairman, (0522-327848)

Department of Transport

R.B. Bhaskar, Principal Secretary (0522-238698)

Department of Energy

Anil Kumar, Principal Secretary (0522-237357)

Department of Information Technology

O.N. Vaid, Principal Secretary, IT & Electronics

Department of Public Enterprises

G.B. Patnaik, Secretary (0522-238200/207327)

Department of Urban Development

J.S. Mishra, Secretary (0522-237314)

Sudhir Kumar Srivastava

U.P. Health Systems Development Project (UPHSDP)

D.S. Mishra, Secretary Medical & Health (0522-354318)

III. JHARKHAND

Department of Externally Aided Projects

Amit Khere, Secretary (0651-403224)

Department of Finance

Ranjan, Secretary Revenue

Pranath Prasad, Commissioner, Excise

Nilam Gupta, Assistance Commissioner, Commercial Taxes

J.P. Singh, Secretary, Pension

Office of Development Commissioner

G. Krishnan, Development Commissioner (0651-252570/252571)

Public Works Department & Building

Ashok Kumar Singh, Secretary (0651-403705)

Department of Minor Irrigation

Mukhtair Singh, Secretary

Directorate of Industries

A.K. Singh, Director

Department of Energy

Sudhir Prasad, Secretary

Department of Science and Technology

J.B. Dubid, Secretary

Department of Human Resource Development, Directorate of Primary Education

B.S. Misra, Director

Department of Human Resource Development, Directorate of Secondary Education

Devi Dayal Prasad, Director

Department of Human Resource Development, Directorate of Higher Education

K.K. Srivastava, Secretary

Department of Urban Development

D. Gupta, Secretary

Narayana, Additional Secretary

S.D. Singh, Administrator Inspector

Srivastava, Deputy Secretary

Masud Hasan, Deputy Secretary

Ranchi Development Authority
R.S. Verma, Vice Chairperson

Department of Rural Development
U.P. Singh, Secretary

Society for Rural Industrialization (NGO)
Indrajit Dey, Secretary (0651-540668)

IV. KARNATAKA

Department of Finance
Gopal Reddy, Principal Secretary (080-2252078)
Subhash Kuntia, Secretary (080-2257336/2092846)
Lakshmi Narayanan, Deputy Secretary
M.N. Aswatha Narayana, Additional Director, Project Monitoring Unit (080-2863053)
Krishna Prasad, Secretary, Commercial Taxes
T. Thimmegowda, Commissioner, Transport Revenue (080-2254900)
Prabhakar, Secretary, Treasury

Tax Reform Commission
Renuka Vishwanathan, Commissioner

Department of Planning
Abhijit Dasgupta, Principal Secretary
Venugopalachari, Secretary
S.M. Vijayaraghavachar, Directorate of Economics and Statistics
Ganashan, Senior Joint Adviser

State Bureau of Public Enterprises
Abhay Prakash, Director General (080-2864448)

Department of Administrative Reforms and Training
Shantanu Consul, Principal Secretary (080-2200634)
Lata Krishna Rao, Secretary

Department of Rural Development
S.L. Gangadharappa, Principal Secretary

Department of Energy
M.N. Vijayakumar, Secretary (080-2381188)

Department of Information Technology
Vivek Kulkarni, Secretary (080-2262466)

V. UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT (USAID)

USAID/Washington

Mark Gellerson, Principal Economist, USAID/Asia Near East Bureau
John Crifield, CTO, SEGIR/Macro-Economic Policy

USAID/India

Walter North, Mission Director

Program Development and Economic Growth (PDEG)

Jerry Tarter, Director

Madhumita Gupta (CTO: State Fiscal/IT Assessments)

N. Ramesh (CTO: Governance Assessment)

Reed Aeschel...(CTO: Pension Reform Assessment)

Office of Population, Health and Nutrition (PHN)

Victor Barbiero, Director

Office of Energy, Environment, Enterprise (E3)

Dick Edwards, Director

John Smith-Sareen

Regional Urban Development Office (RUDO)

Jim Stein, Director

Dave Heesen

N. Bhattachrjee

A.S. Dasgupta

Lee E. Baker, Chief of Party. Financial Institutions Reform and Expansion Project (011-6149836).

C. Baskaran, Group Head (Urban Development), DHV-TCGI Alliance, DHV Consultants (011-6466433).

Chetan Vaidya, Principal Urban Management Advisor, Financial Institutions Reform and Expansion Project (011-6149836)

Pension Team

???

Governance Team

Stark Biddle,

Curt Low,

Other

R.B. Bhaskar. IAS. Principal Secretary. Department of Transport. Tel: 3546648, 345381.

Louis D. Enoff, Enoff Associates Ltd. Tel: 410-549-0455

Manuela V. Enoff, Senior Economist, The World Bank,.

Scott Gibbons, Team Leader, Central Municipal Support Unit. Local Government Engineering Department. Tel: 8130009.

ANNEX XI

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ANNEX XII
List of NGOs in Jharkhand

Mr. M.H. Ansari
Xavier Institute of Social Science (XISS)
Purulia Road
P.O. Box #7
Ranchi – 834 001

Md. Shakeel Anwar, TL, DST (**Regd.Ltr**)
Integrated Development Foundation
C/O Mr. Upendra Prasad Singh, Advocate,
Chiniya Road
Garhwa – 822 114

Mr. Shantanu Banerjee (**Regd.Ltr**)
Regional Manager
Ingersoll Rand
Khanna Niwas
712/D, Circular Road, Lalpur
Ranchi – 854 001
Ph# - 207726/ 202561

Raj Bhawan
Holding #15, Gunomoy Colony
Mango
Jamshedpur 831 012

Mr. Ashish Biswas
Director – CARE
381 A, Room #4
Ashok Nagar
Ranchi
Ph# - 246002 – 4/ Fax – 242049

Ms. Jayanti Dutta
Gram Vikas Kendra
K3/57, Hans Stoehr Road
Telco Colony
Jamsedhpur – 831 004

Dr. Shubra Dwivedi
Socio Economic & Edun Devt Society
(SEEDS)
XLRI Campus
Circuit House Area
Jamshedpur – 831 001

Fr. Franken
Department of Research
Xavier Institute of Social Service (XISS)
Purulia Road, P.O. Box #7
Ranchi – 834 001

Mr. Anil Kumar (**Regd.Ltr**)
PRADAN
Opp. Anand Vihar Lodge
Toklo Road
Chakradharpur – 833 102
West Singhbhum
Ph# - 06587 38535

Ms. Mini Kurup, TL, DST
Integrated Development Foundation
Sewa Sadan Marg
Nawahatta Area
Daltanganj, Palamu

Ms. Maia / Ms. Jain
PRADAN
512 G Road
West Layout, Sonari
Jamshedpur – 831 011
Ph# - 303134
Email: pradanjsr@netcracker.com

Ms. Purbi Pal (**Regd.Ltr**)
Secretary
Shramjivi Mahila Samiti

List of NGOs in Jharkhand (Continued)

Ms. Ekta Rai
Vitamin “A” Focal Point
Social Welfare
Shanti Sadan, Harihar Singh Road
P.O. RMCH
Ranchi – 9
Ph# = 542285

Prof. Anup Sarkar
Department of Research
Xavier Institute of Social Science (XISS)
Purulia Road
P.O. Box #7
Ranchi – 834 001

Dr. R.R. Sinha, Coordinator
BIRD
105 Mita Golden Tower
23 Jail Road (East)
Ranchi – 1
Ph# - 301881

Mr. Ram Balak Rai
Executive Engineer
Public Health & Engineering Dept.
Jamshedpur, Adityapur
Jamshedpur

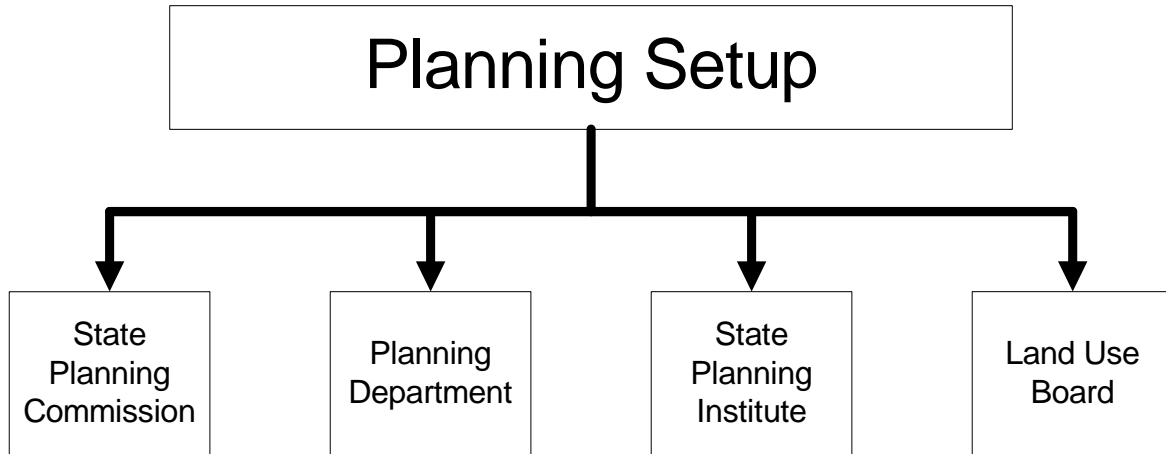
Mr. A.K. Singh, Secretary
Jan Vikas Kendra
Patel Bagan
Sundernagar
Jamshedpur – 832 107

Mr. Tulsidas
District Education Officer
Coordinator – Anemia Control Program
Near Court Compound
Ranchi – 1
Ph# - 311544

ANNEX XIII

Jharkhand Organizational Setup

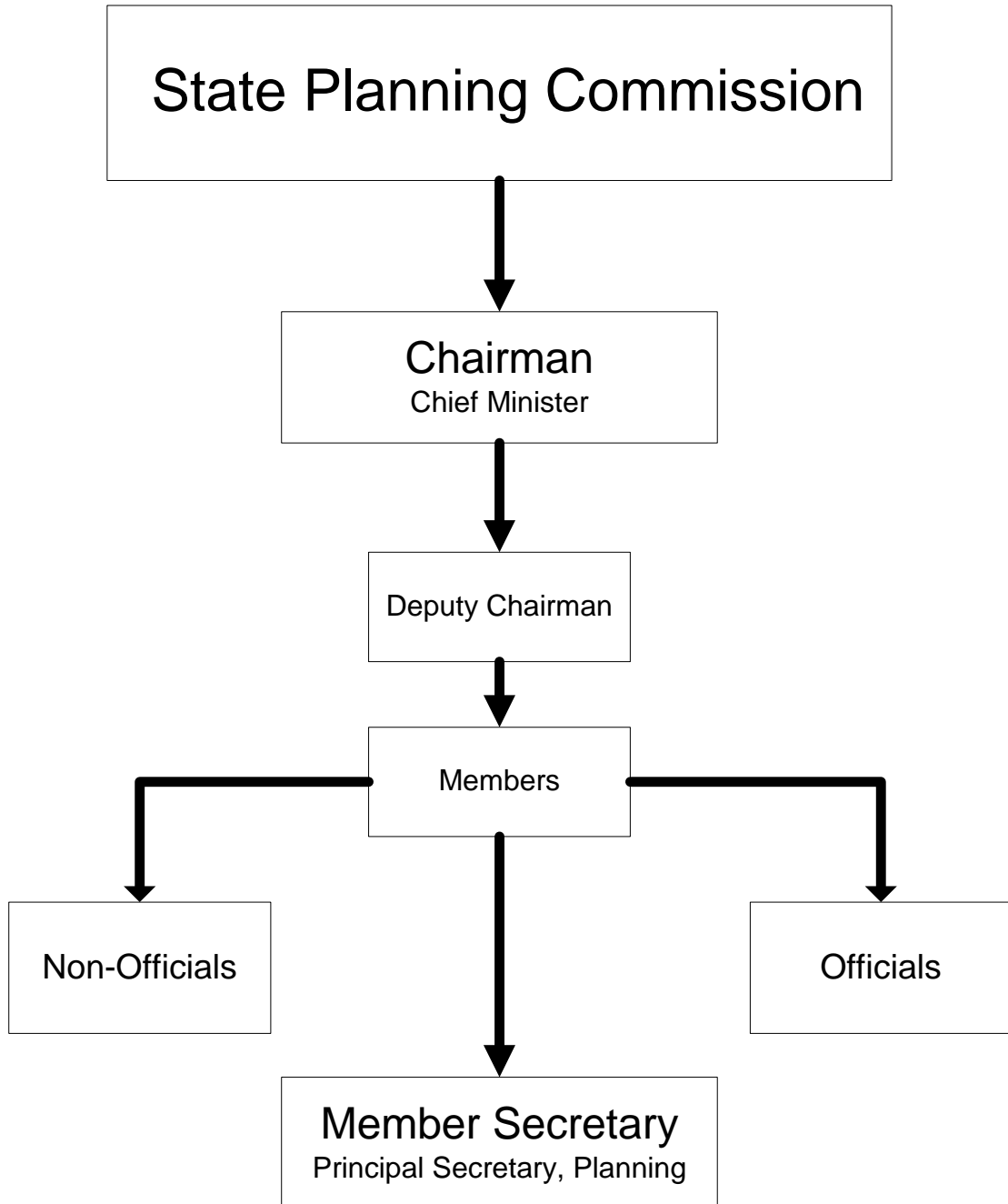
The “Department of Planning” in the State Government is primary responsible for making a plan for the State, to initiate and undertake necessary exercises for this purpose and oversee and take an over-all view of the implementation of the plan, without diluting in any manner the role of different departments of the State government in the formulation and implementation of their respective plans.

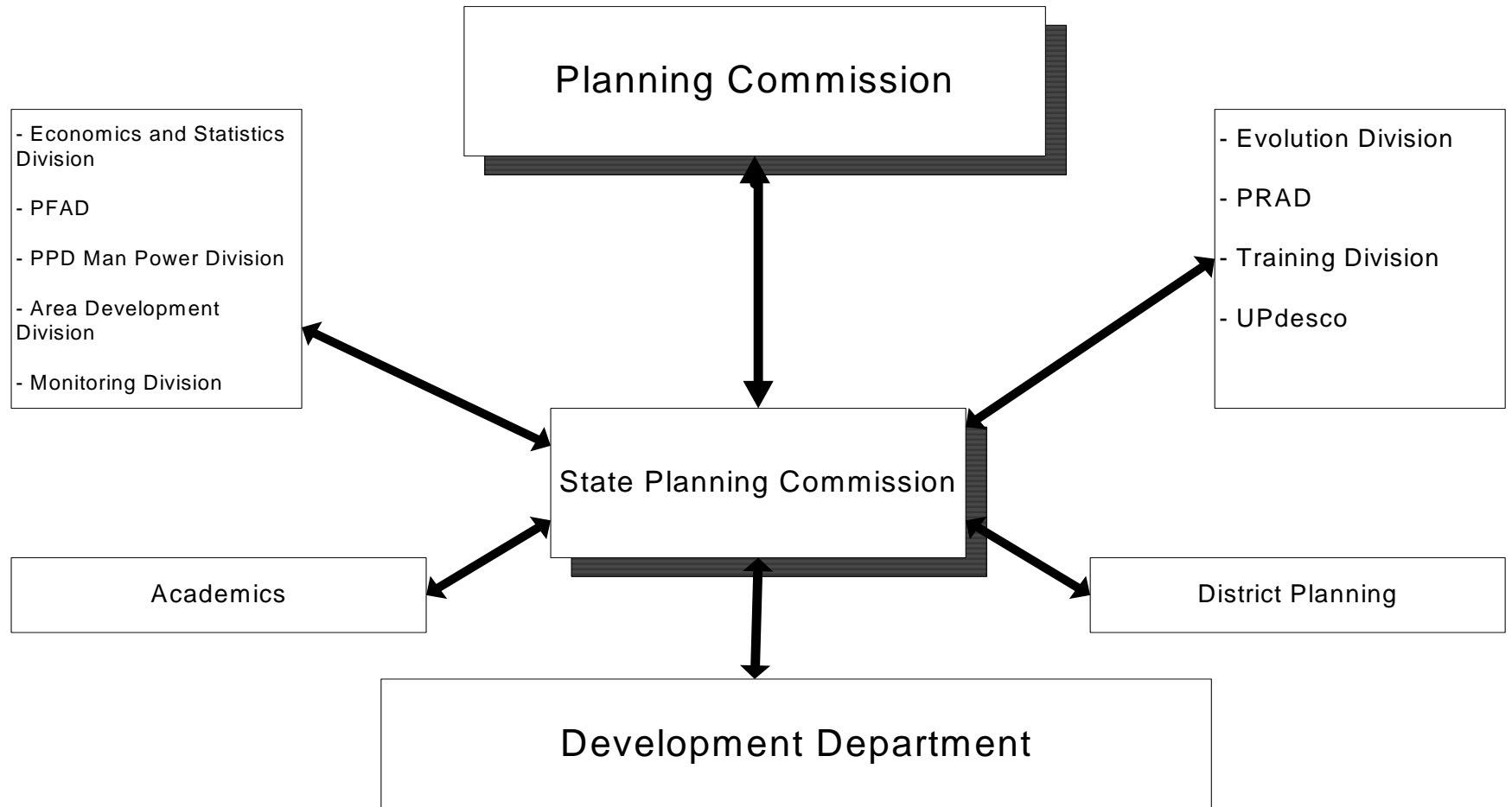


- Planning and Finance are the two main levels of Government
- Department Review of national progress of the project

State Planning Commission

The State Planning Commission is an apex body of the State which was established in 1972 on the advice of National Planning Commission under the chairmanship of Chief Minister. As constituted at present, the State Planning Commission has one Deputy Chairman and 22 other members including State Minister for Planning, Chief Secretary and 7 Secretaries of Major Development Departments and 13 non-official members from various disciplines.





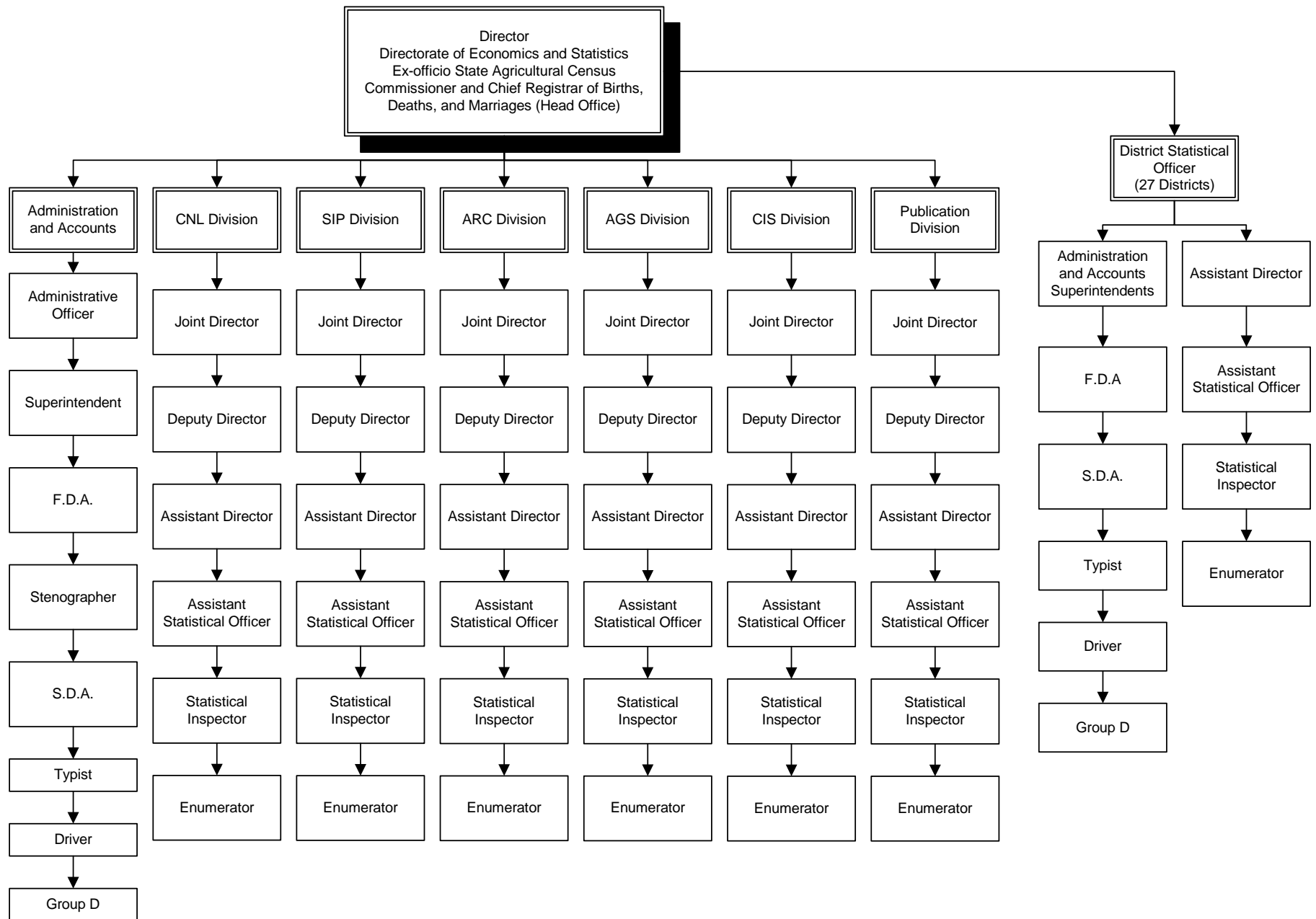
The main objectives of the State Planning Commission are as below:

1. To assess the physical, financial and manpower resources of the State and to take appropriate decisions relating to them.
2. To ensure, conformity of the State Plans with the objectives and priorities of the National Plan.
3. To approve regional and sectoral Plan, both short term and long term, and to aim at balanced, optimum and effective utilization of State resources.
4. To identify factors inhibiting the economic and social development of the State and to indicate solutions for ensuring successful implementation of the Plans.
5. To lay down policies for the removal of regional imbalances within the State.
6. To give necessary direction in the formulation of the Draft Annual Plan.
7. To frame out necessary guidelines for the preparation of the Five Year Plans.
8. Any other work that may be assigned by the State Government.

The following work is being done by the Planning Commission:

1. Formulation of Five Year Plans and Annual Plans.
 - a) Determination of State Government view in regard to approach paper of the Five Year Plans prepared by National Development Plan.
 - b) Putting up State Government's view before the NDC.
 - c) Constitution of Working Groups for formulation of State's Five Year Plan and participation on them.
 - d) Determination of objective and strategy of Five Year Plan of the State.
 - e) Participation in official level discussion in regard to assessment of resources at Planning Commission.
 - f) Finalization of outlay for Five Year & Annual Plans of the State after discussion before Chief Minister & Deputy Chairman, Planning Commission.
 - g) Preparation of Draft Five-Year Plan and Annual Plan.
 - h) Allocation of tentative outlay to development departments.
 - i) Scrutinizing the departmental proposals.
 - j) Finalization of departmental proposals.
2. To obtain approval of Planning Commission after finalization of sectoral outlays.
3. Submission of adjustment proposals for revision of outlay at the end of each financial year.
4. Allocation of finalization of annual plan proposals by allocating approved outlays to development departments.
5. Monthly meetings with development departments to review the financial and physical progress of the annual plan.
6. Coordination of Centrally Sponsored Schemes and correspondence with development departments/Central Planning Commission/Central Ministries.
7. Coordination of Prime Minister Gramodaya Yojana/Border Area Development Program.
8. Works related to Finance Commission.
9. Preparation of guidelines for formulation of district plans and allocation of outlays to districts.
10. Scrutiny and finalization of district plans.
11. Allocation of district share outlay for Poorvanchal Vikas Nidhi and Bundelkhand Vikas Nidhi.
12. Scrutiny and finalization of proposals of the district funds from State share of Nidhis

Directorate of Economics and Statistics Organizational Chart



State Level

Honorable Minister
State Planning and Statistics

Principal Secretary to Government
Planning, Statistics, Science and Technology

Director
Directorate of Economics and Statistics
Ex-Officio Chief Registrar of Births, Deaths, and Marriages
State Agricultural Census Commissioner

Statistical Cell

- Secretariat Department (PD, RD&PR, REV, FD)
- Other Government Departments (33)

Administration and
Accounts

Technical Divisions

ARC AGS
CIS SIP
CNL PTC

Boards and
Corporations (5)

Commissions (2)

District Level

Dist. Statistical Officer (DD)
District Statistical Office (27)

Chief Planning Officers (JD)
Zilla Panchayat (27)

Taluk Level

Taluk Office/Taluka Panchayat Office
S.I./Enumerator/Progress Assistant
(175)

ANNEX XIV

The States' Fiscal Reforms Facility (2000-01 to 2004-5)

1.0 BACKGROUND

The finances of State Governments have shown considerable deterioration in the decade starting 1990-91. A very high Gross Fiscal Deficit (GFD) to GDP ratio has marked this period, for all the States taken together. The debt of States has also gone up as has the Revenue Deficit. The table below summarizes the major trends in States' finances over this period:

Indicator	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000(RE)
Rev. Deficit as percent of GSDP	-0.53	-0.83	-0.88	-1.60	-1.50	-3.19	-3.57
Gross Fiscal Deficit as percent of GSDP	-2.80	-3.24	-3.15	-3.36	-3.58	-5.24	-5.78
Rev. Deficit as percent of GFD	19.05	25.55	28.06	47.61	41.96	60.86	61.83
Debt# as percent of GSDP	22.20	21.68	21.69	21.62	22.48	23.99	25.87
Guarantees* as percent of GSDP	6.78	6.72	7.30	8.79	10.23	11.52	13.80

Debt Outstanding at the end of each year and includes internal debt, Loans from Center and PF & Small Savings.

*Guarantees outstanding at the end of each year and pertains to 17 major States – (SOURCE: RBI).

NOTE: GSDP State's new series (1993-94=100) is applied except in case of J&K and Nagaland where old series is used (1980-81=100)

Fiscal reforms at State level has thus become an urgent component of overall economic reforms. Restructuring of Indian Public Finance requires the collective action of both layers of the Government, namely the Central and State Governments. In recognition of this reality, one of the crucial terms of reference of the Eleventh Finance Commission (EFC) was to review "the state of finances of the Union and the States and suggest ways and means by which the Governments collectively and severally may bring about a restructuring of the Public Finances so as to restore budgetary balance and maintain macro-economic stability."

2.0 THE EFC REPORTS

The reports mainly deal with grants to States in the context of revenue deficit in the accounts of the States. In respect of revenue deficit grants of States, the Commission's recommendations in their three Reports are summarized below:

- In the Interim Report submitted on January 15, 2000, the Commission had recommended a lump sum provision of Rs. 11000 crore in the Central Budget 2000-01 for revenue deficit grants to States without giving Statewise break-up.
- In the Main Report submitted on July 7, 2000, the Commission recommended revenue deficit grants of Rs.35359 crore for 15 States during 2000-05. The remaining 10 States were revenue surplus in the Commission's assessment. The Commission was asked to draw up a monitorable fiscal reforms program and to recommend how to link the release of revenue deficit grants to progress in implementing the program.

- Since only 15 States were assessed to be in revenue deficit, the fiscal reforms program should have normally covered only the 15 States assessed to be in revenue deficit. Instead, in the Supplementary Report submitted on August 30, 2000, the majority view in the Commission has recommended monitorable fiscal reforms programs for all States. It has been recommended that 15 percent of the revenue deficit grants meant for 15 States during 2000-05 and a matching contribution by Central Government be credited into an Incentive Fund from which fiscal performance based grants should be made available to all 25 States. Release of performance based grants from an Incentive Fund to be set up by withholding 15 percent of the Rs.35359 crore deficit grants for 15 States and an equal matching contribution by Government of India with yearwise phasing as follows:

Composition of the Incentive Fund (Rs. In crore)			
Year	Withheld portion of the revenue deficit grants	Contribution of the Center	Total Fund
2000-01	1523.06	598.48	2121.54
2001-02	1080.43	1041.11	2121.54
2002-03	994.64	1126.91	2121.55
2003-04	861.74	1259.81	2121.55
2004-05	843.99	1277.55	2121.54
Total	5303.86	5303.86	10607.72

- **The Commission has also recommended that the grants for specific purposes like upgradation, special problems and local bodies, which remain unutilized due to non-observance of conditionalities attached to the release of these grants may also be credited to the Incentive Fund during 2004-05.**

2.1 The important features of the scheme proposed by the EFC in the Supplementary Report are as follows:

- I. Eighty-five percent of the revenue deficit grant recommended by the Commission and accepted by the Government of India may be released to the relevant States without linking it to performance under the monitorable fiscal reforms program. Only 15 percent of the revenue deficit grant to which a State is entitled may be withheld and linked with the progress in performance.
- II. The Incentive Fund should be set up comprising of two parts. The first part of the Fund would comprise 15 percent of the withheld part of the grants recommended to cover the deficit of the States on non-plan revenue account. Depending on the performance of a State in the implementation of the monitorable program, the withheld amount would be released to it on a proportionate basis. The second part of the Fund would be created by contribution from the Central Government, equivalent to 15 percent of the revenue deficit grants recommended by the Commission.

- III. The incentive component is recommended to be provided to all the States. The initial eligibility of the States has been worked out on the basis of the population as per the 1971 Census. The amount will be available to a State in proportion to the level of performance in the implementation of the monitorable fiscal reforms program for each year.
- IV. If any State is unable to get the full amount initially earmarked for it in any year, such amount will not lapse but will continue to be available in subsequent years to the same State. During the first four years, no amount of this Fund earmarked for assistance/incentive to a State, would be transferred to another State. However, if any State is not able to draw the amount indicated on the basis of the performance of the first four years, the amount undisbursed to a State would form part of the common pool and would be distributed to the performing States in the fifth year on a pro-rata basis in addition to the amounts to which they are initially entitled. The same would apply to the undrawn amount of the withheld portion of the grants to cover non-plan revenue deficit. Every State irrespective of the assessed deficit or not would be entitled to get the assistance on a pro-rata basis related to performance from the additions to the Fund. This additional entitlement can go up to 100 percent of their initial eligibility indicated for the State concerned.
- V. The withheld amount of grants releasable in 2004-05 may be released to the concerned assessed State on the basis of a review of their performance. In case any amount remains unreleased to a State, it would be added to the Fund and would be available to the remaining States. The balance amount in the Fund at the end of 2005-06 will lapse to the Central Government.
- VI. The Commission had recommended grants for specific purposes like upgradation, special problems and local bodies in the Main Report. There are certain specific conditionalities for releasing these grants. The progress in the implementation of the identified schemes may be reviewed by the Monitoring Agency. If the Agency is satisfied that a State has not taken effective steps to implement these in the first four years, and is not in a position to utilize the amount either in full or in part, the same may be added to the Incentive Fund in the fifth year.
- VII. In addition to the incentives for better performance, Central Government may also consider the fiscal reforms program linked assistance by way of extended-ways and means advance and additional open market borrowings. The scope and dimension of such facilities should be drawn up by the Central Government bearing in mind the Center's fiscal position and the macro-economic implications of this facility. This facility should also be extended to all States linked to monitorable fiscal reforms program drawn up for the State.**
- VIII. The disbursements from the Incentive Fund as well as the utilization of the grants recommended by the 11th Finance Commission in the Main Report will be subject to review by the 12th Finance Commission.

3.0 FISCAL OBJECTIVES SET BY THE EFC

Chapter 3 of the EFC's Main Report lays down the broad parameter of fiscal correction in the State Sector. Starting with the base year of 1999-2000, each State is expected to take effective steps for revenue augmentation and expenditure compression over the five-year period so as to broadly achieve the following objectives:

- Gross Fiscal Deficit of the States as an aggregate to fall to 2.5 percent of GSDP.
- Revenue deficit of all States, in an aggregate, falling to zero.
- Interest payments as a percentage of revenue receipts of the State Sector as a whole – 18 to 20 percent.

In the Supplementary Report the EFC has also suggested the following objectives:

- a) Increases in wages and salaries should not exceed 5 percent or increase in the consumer price index whichever is higher.
- b) Increase in interest payments (in absolute terms) may be limited to 10 percent per year.
- c) Explicit subsidies to be brought down by 50 percent over the next five-year period with a view to eliminate subsidies altogether by 2009-2010.

4.0 MEDIUM TERM FISCAL RESTRUCTURING POLICY

Given the broad contours of the fiscal objectives sketched above, the State Governments should draw up a Medium Term Fiscal Restructuring Policy (MTFRP). The Policy needs to dovetail time-bound action points such as:

(A) FISCAL OBJECTIVES & REFORMS

- Widening the tax base;
- Increasing tax rates on a year to year basis;
- Pricing services such as irrigation, water charges, bus fares, to an identified base, computing the subsidy element and preparing a schedule to reduce the subsidy element;
- Indexation of prices/user-charges to major input costs such as POL, Dearness Allowance, etc;
- Abolition of vacant posts in Government except Primary School Teachers, Health Workers;
- New teachers to be appointed on contract basis as in Rajasthan and Madhya Pradesh;

- Work charged establishment to be redeployed for new capital works. Practice of engaging new work-charge staff and daily-wage workers to be stopped forthwith;
- Tapering off subventions to G.I.A. Institutions. Registration of new Grant-in-Aid institutions in secondary and higher education to be phased out over five years.

(B) POWER SECTOR REFORMS

Power Sector reforms would aim at reducing the negative contribution of the SEBs to the States' Revenues. While Ministry of Power is separately working out a set of monitorable Reform milestones, the basic ingredients would include:

- Achieving an average tariff equal to the cost of power within 2 years;
- Setting up of State Regulatory Electricity Commissions (SRECs);
- Implementing the awards of the SRECs;
- Unbundling of basic services - generation, transmission and distribution OR setting up separate profit centers;
- Reducing T&D losses by 5 percent every year;
- Metering up to 11 KV sub-station level.

(C) PUBLIC SECTOR RESTRUCTURING

The Public Sector Restructuring Component should have two basic subsets. Each State should identify the need of continuing certain activities within the State domain. This would be regardless of whether the PSE is making profits or commercial losses. Primary among these would be PSEs that are in manufacturing activities such as Electronics, Wireless, Textiles and Tractors to cite a few examples. A road map for PSRP would be:

- Identify PSEs with a view to determining the need for Government to continue as owners;
- For loss making PSEs, a comprehensive VRS package to be drawn-up;
- A time-bound road map for winding up such PSEs be laid down;
- For commercially profitable PSEs, Government to decide - either through a High Powered Committee or otherwise - the extent of dilution in Government share holding. Depending on the nature of PSE, Government share holding should be reduced to:
 - 0 percent - total privatization
 - 26 percent - giving shareholders rights in AGMs and EGMs
 - 49 percent - where despite privatization Government would still exercise managerial control;
- Further infusion of Government funds either by way of equity or loans be phased out over 5 years to PSEs, unless such PSEs are identified to be socially desirable.

(D) BUDGETARY REFORMS

The EFC has laid stress on certain modifications in the budgetmaking process of States, as well as the way in which data is presented. Specifically the following issues should be laid down:

- A separate schedule in each State Government budget giving the total expenditure on salaries and allowances;
- A separate schedule on pensions and terminal benefit outflows;
- A schemewise, sectorwise schedule of subsidies (explicit) from the State budget;
- A schedule of yearwise and projectwise guarantees outstanding;
- Annexure II to this note captures the basic ingredients of fiscal transparency. While this document will form a basic monitoring input for monitoring the FRF, States may consider presenting this document as a part of the State Budget.

5.0 MONITORING OF FISCAL REFORM

Pursuant to the receipts of these guidelines, each State must draw up the Medium Term Fiscal Reforms Program (MTFRP). While flexibility in designing the MTFRP is broadly left to the States the following principles should form the minimum requirement of each State:

RELEASES FROM THE INCENTIVE FUND WILL BE BASED ON A SINGLE MONITORABLE FISCAL OBJECTIVE. EACH STATE WILL BE EXPECTED TO ACHIEVE A MINIMUM IMPROVEMENT OF 5 PERCENT IN THE REVENUE DEFICIT (SURPLUS) AS A PROPORTION OF THEIR REVENUE RECEIPT EACH YEAR TILL 2004-05. THE BASE YEAR WILL BE FINANCIAL YEAR 1999-2000.

EXPLANATIONS

- (a) If a State 'A' falls short of an improvement of 5 percent in year (t+1) compared to the previous year, t, the State will not be eligible to draw upon its share from the Incentive Fund for that year. The amount of the Fund will be carried over to the next year, (t+2);
- (b) If in year (t+2) State 'A' shows an improvement of over 10 percent compared to the base year 't', the State shall be entitled to its share of the Incentive Fund for the year (t+2) as well as the withheld portion of year (t+1);
- (c) If, however, the improvement in year (t+2) is 6 percent compared to year (t+1) the State shall be eligible for its share for the year (t+2) but not for the year (t+1). The withheld portion of year (t+1) will then be carried over to year (t+3);

- (d) Paragraphs 8.3 to 8.7 of the Supplementary Report of the EFC clarifies the mechanism for releases from the Incentive Fund, which inter-alia also includes withheld portion of the Revenue Deficit Grants to States, and also such other discretionary releases to States as additional Open Market Borrowings and extended Ways & Means that may be allotted to States in the duration of the scheme period.
- (e) The Revenue Deficit should be clearly understood to be inclusive of:
 - (i) Contingent liabilities such as guarantees and letters of comfort due in that year which would directly constitute a budget liabilities; and
 - (ii) Subsidies due to PSEs, whether or not the State Pays such a subsidy upfront. Thus, a budget subsidy payable to the SEB will be “recognized” as a Revenue Expenditure, for purposes of computing the Revenue Deficit.
- (f) **Financial year 2004-05 is the final year of the EFC Award. However, in the course of the year only the financial details of 2003-2004 (RE) will be available thus, starting from base year 1999-2000, States may expect releases of the entire Incentive Fund if they achieve a 20 percent improvement in revenue deficit (or surplus) as proportion of the revenue receipts. Details of improvement of each State are given in *Annexure I*. It will be seen that by the financial year 2005-2006 if the trend of the improvement continues, the States Sector as a whole will come into revenue balance.**

States should draw up the Medium Term Fiscal Reform Program (MTFRP) as suggested above. Monitoring of the facility would be a joint exercise conducted on the basis of components of the MTFRP and the improvement in revenue balance captured in the form given in *Annexure II*. **This should form the basis of a Memorandum of Understanding (MoU) entered into between each State and Ministry of Finance, as a preliminary exercise.**

6.0 MONITORING COMMITTEE

The States Fiscal Reform Facility and the MTFRP is essentially the States’ own program. Considerable flexibility in designing the policy framework has been left to the initiative of the State Governments. However, the States fiscal health is an important component of the country’s overall macro-economic balance. Monitoring the program is, to that extent, a collaborative exercise between the Center and the States. A Committee comprising of:

- (i) Secretary (Expenditure) in the Ministry of Finance
- (ii) Secretary, Planning Commission
- (iii) Deputy Governor, Reserve Bank of India
- (iv) Chief Economic Adviser, DEA, Ministry of Finance
- (v) An outside Expert
- (vi) The Chief Secretary of the State and
- (vii) The Finance Secretary of the State concerned.

will form the Monitoring Committee. JS(PF-I) in the Ministry of Finance will be the Member-Secretary of this Monitoring Committee. The Fiscal Reform Unit in the FCD will be the single window Secretariat for the Fiscal Reform Program under this scheme as well as any other supplementary facility that may be extended to States from time to time, including, *inter-alia*, facilities from multilateral lending agencies.

On receipt of these guidelines States may immediately embark upon the exercise of drawing up the MTFRP dovetailing the same with improvements in the revenue balance before entering into a MoU with the Government of India.

(R. Bannerji)
Joint Secretary (PF-I)
Chief Secretaries of All States

Annexure XIV-1
Revenue Deficit as Percent of Revenue Receipts

S.No.	States	1999-00(RE)	2000-01	2001-02	2002-03	2003-04	2004-05
1	Andhra Pradesh	-15.61	-10.61	-5.61	-0.61	4.39	9.39
2	Arunachal Pradesh	14.77	19.77	24.77	29.77	34.77	39.77
3	Assam	-23.40	-18.40	-13.40	-8.40	-3.40	1.60
4	Bihar	-28.22	-23.22	-18.22	-13.22	-8.22	-3.22
5	Goa	-18.35	-13.35	-8.35	-3.35	1.65	6.65
6	Gujarat	-19.04	-14.04	-9.04	-4.04	0.96	5.96
7	Haryana	-21.59	-16.59	-11.59	-6.59	-1.59	3.41
8	Himachal Pradesh	-6.66	-1.66	3.34	8.34	13.34	18.34
9	J&K	-2.26	2.74	7.74	12.74	17.74	22.74
10	Karnataka	-12.01	-7.01	-2.01	2.99	7.99	12.99
11	Kerala	-28.40	-23.40	-18.40	-13.40	-8.40	-3.40
12	Madhya Pradesh	-18.95	-13.95	-8.95	-3.95	1.05	6.05
13	Maharashtra	-38.86	-33.86	-28.86	-23.86	-18.86	-13.86
14	Manipur	-22.23	-17.23	-12.23	-7.23	-2.23	2.77
15	Meghalaya	-1.35	3.65	8.65	13.65	18.65	23.65
16	Mizoram	-2.49	2.51	7.51	12.51	17.51	22.51
17	Nagaland	-3.17	1.83	6.83	11.83	16.83	21.83
18	Orissa	-33.43	-28.43	-23.43	-18.43	-13.43	-8.43
19	Punjab	-37.03	-32.03	-27.03	-22.03	-17.03	-12.03
20	Rajasthan	-38.58	-33.58	-28.58	-23.58	-18.58	-13.58
21	Sikkim	0.02	5.02	10.02	15.02	20.02	25.02
22	TN	-22.48	-17.48	-12.48	-7.48	-2.48	2.52
23	Tripura	-9.95	-4.95	0.05	5.05	10.05	15.05
24	UP	-34.99	-29.99	-24.99	-19.99	-14.99	-9.99
25	WB	-70.67	-65.67	-60.67	-55.67	-50.67	-45.67
	All States	-27.40	-22.40	-17.40	-12.40	-7.40	-2.40

Annexure XIV-2 (Format)
Government of _____
Finance Department Budget at a Glance
Consolidated Statement on Receipts and Expenditure (Rs. Crore)

RECEIPTS & EXPENDITURE	1999-2000		2000-2001		2001-02
	RE	Actual	BE	RE	BE
1. REVENUE RECEIPTS (1.1 TO 1.6)					
1.1 State's own Tax Revenue					
1.2 Share in Central Taxes & <i>Duties</i>					
1.3 State's own non-tax revenue					
of which Lotteries (Gross Receipts)					
1.4 <i>Plan Grants</i>					
i) State Plan Schemes (Central Asst.)					
ii) Grants for CSS/CPS					
1.5 Grants from Finance Commission					
i) <i>Non-Plan</i>					
ii) <i>Plan</i>					
1.6 Non-Plan Grants <i>other than F.C.</i>					
2. REVENUE EXPENDITURE (2.1 + 2.2)					
2.1 Plan Revenue Expenditure, of which					
2.1.1 Outlay on CSS/CPS					
2.1.2 Support to State PSUs					
2.1.3 Lotteries (Gross Expenditure)					
2.2 Non-Plan Revenue Expenditure, of which					
2.2.1 Interest Payment					
2.2.2 Support to State PSUs					
2.2.3 Lotteries (Gross Expenditure)					
3. CAPITAL RECEIPTS (3.1 TO 3.15)					
3.1 SLR based Market borrowings (Gross)					
3.2 Negotiated Loans (Budgeted)					
3.3 Loans for State Plan Schemes (Central Asst.)					
3.4 Loans against Net Small Savings					
3.5 Loans for Central Plan Schemes					
3.6 Loans for Central Sponsored Schemes					
3.7 <i>W&M advance from RBI (Net)</i>					
3.8 W&M advances from Center					
3.9 Recovery of Loans & Advances					
3.10 Disinvestment					
3.11 Contingency Fund (Net)					
3.12 Appropriation to Contingency Fund (Net)					
3.13 <i>Inter-State Settlement (Net)</i>					
3.14 Other capital receipts into Consolidated Fund					
3.15 Public Account (Net), of which					
Provident Fund (Net)					
Reserve Fund (Net)					
Deposits & Advances (Net/Budgeted), of which					
<i>Deposits (Net/Budgeted)</i>					
Suspense & Miscellaneous (Net)					
Withdrawal from Cash Balance Investment Account (Net)					
Remittances (Net)					
Others (Net)					

CONSOLIDATED STATEMENT ON RECEIPTS AND EXPENDITURE (Rs. Crore)

RECEIPTS & EXPENDITURE	1999-2000	2000-2001	2001-02
	RE	Actual	BE
4. CAPITAL EXPENDITURE (4.1 TO 4.6)			
4.1 Plan Capital Outlay			
of which outlay on CSS/CPS			
4.2 Plan Lending			
of which lending on CSS/CPS			
4.3 Non-Plan Capital Outlay			
4.4 Non-Plan Lending			
4.5 Discharge of Internal Debt			
of which Market Borrowings			
4.6 Repayment of Loans to Center			
A. TOTAL RECEIPTS (1+3)			
B. TOTAL EXPENDITURE (2+4)			
C. OVERALL SURPLUS (+)/DEFICIT(-)(A-B)			
D. OPENING BALANCE			
E. CLOSING BALANCE (C+D)			
F. REVENUE SURPLUS (+)/DEFICIT(-)(1-2)			
G. GROSS FISCAL DEFICIT			
(1=3.9+3.10) – (4.1 TO 4.4+2)			
H. PRIMARY DEFICIT (+) (G-Interest Payments)			
I. STATE'S OWN RESOURCES (i to x)			
i. Balance from Current Revenues			
(1.1+1.2+1.3+1.5i+1.6-2.2+N.P.support to PSUs)			
ii. Net Contribution from State PSUs			
(Non-Plan support to state PSUs)			
iii. Plan Grants under FC (1.5)			
iv. MCR (net) (3.7 to 3.15(-)GPF (-) 4.3 to 4.6)			
v. Net Provident Fund			
vi. Loans against Net Small Savings (3.4)			
vii. SLR based Borrowings (Gross) (3.1)			
viii. Negotiated Loans (3.2)			
ix. Adjustment of Opening Balance (D-E)			
x. CSS/CPS Deficit (-)/Surplus (+)			
(Receipts - Disbursements)			
J. CENTRAL ASSISTANCE (1.4i+3.3)			
K. STATE PLAN RESOURCES (I+J)			
L. STATE PLAN OUTLAY (=K) OR			
(2.1+4.1+4.2 – outlay on CSS/C(S))			

Items such as positive contribution from State Public Sector units and negotiated loans/bonds guaranteed by State Government that do not enter either Consolidated Fund or Public Account constitute extrabudgetary resources. As such these are excluded from the Consolidated Statement on Receipts and Disbursements, the latter exclusively reflecting the budgetary transactions of Government.

IMPORTANT ITEMS OF RECEIPTS (Rs. Crore)

RECEIPTS	1999-2000		2000-2001		2001-02
	RE	Actual	BE	RE	BE
TOTAL (REVENUE + CAPITAL RECEIPTS)					
1. Share of Central Taxes					
2. Non-Plan grants under FC and GOI					
3. Devolution under CSS/CPS					
4. Formula based Central Assistance					
5. ACA for_____					
6. Other ACA (non-formula based)					
7. Share of loans against small savings					
8. SLR (based) Market Borrowings					
9. Negotiated Loans (Entering Consolidated Fund)					
10. Bonds Entering Public Account					
11. Sales Tax					
12. Excise					
13. Motor Vehicles & Passenger Tax					
14. Stamps & Registration					
15. Luxury & Entertainment Tax					
16. State's non-tax revenue					
17. Others #					

The choice of items is totally illustrative. State Governments may choose items in descending order of size in their budgeted receipts.

Important receipts under States non-tax revenue like Royalty from Mines & Minerals, Environment & Forestry, etc. Receipts from Electricity & Road Transport to be included only if these are departmental.

Items 1 to 17 must add up to total receipts as in the Consolidated Statement on Receipts & Expenditure.

POSITIVE CONTRIBUTION FROM STATE PSUs TOTAL DEBT AND GUARANTEES (Rs.Crore)

RECEIPTS	1999-2000		2000-2001		2001-02
	RE	Actual	BE	RE	BE
1. Positive Contribution from State PSUs					
a. SEB					
b. SRTC					
c. Others					
2. Total Debt (Capital receipts less non-debt)					
a. Current					
b. Outstanding					
3. Total guarantees*					
a. Current					
b. Outstanding					

* *Total guarantees to be reported regardless of whether these enter Government Accounts. However, what does enter Government Accounts may be indicated in the parentheses.*

IMPORTANT ALLOCATIONS AT THE ORIGIN MAJOR HEADWISE
(Rs.Crore)

EXPENDITURE	1999-2000		2000-2001		2001-02
	RE	Actual	BE	RE	BE
TOTAL (REVENUE+CAPITAL EXPENDITURE)					
(to be shown separately for Revenue & Capital Account)					
Non-Plan					
State Plan					
CSS/CPS					
1. Education, Sports, Art & Culture					
Non-Plan					
State Plan					
CSS/CPS					
of which					
(i) <i>Elementary Education</i>					
Non-Plan					
State Plan					
CSS/CPS					
(ii) <i>Others</i>					
Non-Plan					
State Plan					
CSS/CPS					
2. Medical & Public Health					
Non-Plan					
State Plan					
CSS/CPS					
of which					
(i) <i>Rural Primary Health & Prevention/</i> <i>Control of diseases</i>					
Non-Plan					
State Plan					
CSS/CPS					
(ii) <i>Others</i>					
Non-Plan					
State Plan					
CSS/CPS					
3. Family Welfare					
Non-Plan					
State Plan					
CSS/CPS					
4. Water Supply & Sanitation					
Non-Plan					
State Plan					
CSS/CPS					
5. Public Works					
Non-Plan					
State Plan					
CSS/CPS					
6. Crop Husbandry					
Non-Plan					
State Plan					
CSS/CPS					

IMPORTANT ALLOCATIONS AT THE ORIGIN-MAJOR HEADWISE (continued)
(Rs.Crore)

EXPENDITURE	1999-2000		2000-2001		2001-02
	RE	Actual	BE	RE	BE
7. Major & Medium Irrigation					
Non-Plan					
State Plan					
CSS/CPS					
8. Major Irrigation					
Non-Plan					
State Plan					
CSS/CPS					
9. Roads & Bridges					
Non-Plan					
State Plan					
CSS/CPS					
10. Power					
Non-Plan					
State Plan					
CSS/CPS					
11. Transport					
Non-Plan					
State Plan					
CSS/CPS					
12. Others**					
Non-Plan					
State Plan					
CSS/CPS					

*** As in the Statement on important receipts, the statement on important allocations is only illustrative. State Governments may choose items that are in descending order of size in their budgeted expenditure. Items 1 to 12 must add up to total expenditure as in the Consolidated Statement on Receipts & Expenditure.*

IMPORTANT ALLOCATIONS AT THE DESTINATION – DETAILED HEADWISE
(Rs.Crore)

EXPENDITURE	1999-2000		2000-2001		2001-02
	RE	Actual	BE	RE	BE
TOTAL (REVENUE+CAPITAL EXPENDITURE)					
1. Salaries, of which					
Government					
Local Bodies					
Teachers					
2. Wages					
3. Office Expenses					
4. Travel Allowances					
5. Rent					
6. Motor Vehicles					
7. Petroleum, Oil & Lubricant					
8. Maintenance					
9. Materials & Supplies					
10. Machinery & Equipment					
11. Dietary Charges					
12. Minor Works					
13. Major Works					
14. Subsidies*					
15. Investment					
16. Loans (Lending as well as repayment)					
17. Interest					
18. Grant-in-aid+					
19. Pensions					
20. Other \$					

The list of detailed heads is not exhaustive. State Governments may however include all detailed heads that are functional in their budgets. Total must add up to total expenditures as in the Consolidated Statement on receipts and expenditure.

** Includes both Explicit and Implicit subsidies. + Excludes Grants in Aid for payment of salaries to local bodies and teachers. \$Please specify.*

EXPLICIT AND IMPLICIT SUBSIDIES
(Rs.Crore)

ITEM	1998-99	1999-2000	2000-01
Subsidies (sectorwise)			
of which			
Explicit			
Implicit*			

** includes revenue foregone by way of Concessions/incentives/user charges.*

TOTAL NUMBER OF STATE GOVERNMENT EMPLOYEES
(Nos)

ITEMS	1998-99	1999-2000	2000-01
Total Employees, of which			
State Government			
Employees			
Employees of State PSUs			
Employees of Other States			
Undertakings			
Teachers (State Government)			

** includes revenue foregone by way of Concessions/incentives/user charges.*

TOTAL NUMBER OF LOCAL BODIES EMPLOYEES
(Nos)

ITEMS	1998-99	1999-2000	2000-01
Total Employees, of which			
Local Bodies Employees			
Teachers (State Government)			

COMPARATIVE STATEMENT OF CONTINGENT LIABILITIES OUTSTANDING
(Rs. in Crore)

	1998-99	1999-2000	2000-01
	Outstanding	Outstanding	Outstanding
	Commission	Commission	Commission
	Fee on Default	Fee on Default	Fee on Default
Institutions			
Guarantee			
1.a SEBs			
1.b Public Sector Undertakings			
1.c Grant-in Aid Institutions			
2.a Co-operatives			
2.b Agricultural Banks			
2.c State Co-operative Banks			
2.d Marketing Co-operatives			
2.e Consumer Co-operatives			
3.a Industrial Co-operatives			
3.b Coir			
3.c Handloom			
3.d Others			
4.a Local Bodies			
4.b Development Authorities			
5.a Letter of Comfort			
5.b SPVs			
5.c IPPs			
6. Other Contingent Liabilities			
Grand Total			

Annexure XIV-3
Distribution of Grants from the Incentive Fund (withheld portion and contribution from the Center)
(Rs. In Crore)

States	2000-01			2001-02			2002-03			2003-04			2004-05			Total (2000-05)		
	Part A	Part B	Total	Part A	Part B	Total	Part A	Part B	Total	Part A	Part B	Total	Part A	Part B	Total	Part A	Part B	Total
Andhra Pradesh	0.00	47.94	47.94	0.00	83.40	83.40	0.00	90.27	90.27	0.00	100.92	100.92	0.00	102.34	102.34	0.00	424.87	424.87
Arunachal Pradesh	36.69	0.52	37.21	37.01	0.90	37.91	36.92	0.97	37.89	36.28	1.09	37.37	37.28	1.10	38.38	184.18	4.58	188.76
Assam	16.60	16.12	32.72	0.00	28.04	28.04	0.00	30.35	30.35	0.00	33.93	33.93	0.00	34.40	34.40	16.60	142.84	159.44
Bihar	0.00	46.42	46.42	0.00	80.76	80.76	0.00	87.40	87.40	0.00	97.72	97.72	0.00	99.11	99.11	0.00	411.41	411.41
Goa	0.00	0.88	0.88	0.00	1.52	1.52	0.00	1.65	1.65	0.00	1.84	1.84	0.00	1.87	1.87	0.00	7.76	7.76
Gujarat	0.00	29.42	29.42	0.00	51.18	51.18	0.00	55.40	55.40	0.00	61.93	61.93	0.00	62.80	62.80	0.00	260.73	260.73
Haryana	0.00	11.06	11.06	0.00	19.24	19.24	0.00	20.83	20.83	0.00	23.28	23.28	0.00	23.61	23.61	0.00	98.02	98.02
Himachal Pradesh	157.42	3.81	161.23	150.33	6.63	156.96	141.98	7.18	149.16	125.88	8.03	133.91	106.78	8.14	114.92	682.39	33.79	716.18
Jammu & Kashmir	316.75	5.09	321.84	336.13	8.85	344.98	335.91	9.58	345.49	343.60	10.71	354.31	349.29	10.86	360.15	1681.68	45.09	1726.77
Karnataka	0.00	32.29	32.29	0.00	56.17	56.17	0.00	60.80	60.80	0.00	67.97	67.97	0.00	68.92	68.92	0.00	286.15	286.15
Kerala	0.00	23.52	23.52	0.00	40.92	40.92	0.00	44.30	44.30	0.00	49.52	49.52	0.00	50.22	50.22	0.00	208.48	208.48
Madhya Pradesh	0.00	33.08	33.08	0.00	57.54	57.54	0.00	62.27	62.27	0.00	69.63	69.63	0.00	70.62	70.62	0.00	293.14	293.14
Maharastra	0.00	55.55	55.55	0.00	96.64	96.64	0.00	104.61	104.61	0.00	116.94	116.94	0.00	118.59	118.59	0.00	492.33	492.33
Manipur	53.20	1.18	54.38	53.26	2.06	55.32	52.80	2.23	55.03	51.69	2.49	54.18	50.80	2.52	53.32	261.75	10.48	272.23
Meghalaya	50.72	1.12	51.84	49.56	1.94	51.50	48.93	2.10	51.03	45.14	2.35	47.49	41.51	2.38	43.89	235.86	9.89	245.75
Mizoram	48.42	0.37	48.79	49.44	0.64	50.08	50.22	0.69	50.91	52.66	0.77	53.43	50.71	0.78	51.49	251.45	3.25	254.70
Nagaland	96.65	0.57	97.22	101.09	0.99	102.08	108.02	1.07	109.09	110.11	1.20	111.31	114.57	1.21	115.78	530.44	5.04	535.48
Orissa	53.77	24.18	77.95	5.46	42.07	47.53	41.80	45.54	87.34	0.00	50.91	50.91	0.00	51.62	51.62	101.03	214.32	315.35
Punjab	42.63	14.93	57.56	0.00	25.98	25.98	0.00	28.12	28.12	0.00	31.43	31.43	0.00	31.88	31.88	42.63	132.34	174.97
Rajasthan	143.29	28.39	171.68	43.41	49.39	92.80	0.00	53.47	53.47	0.00	59.77	59.77	0.00	60.61	60.61	186.70	251.63	438.33
Sikkim	25.46	0.23	25.69	25.61	0.40	26.01	25.48	0.44	25.92	24.97	0.49	25.46	24.58	0.49	25.07	126.10	2.05	128.15
Tamil Nadu	0.00	45.40	45.40	0.00	78.98	78.98	0.00	85.49	85.49	0.00	95.57	95.57	0.00	96.92	96.92	0.00	402.36	402.36
Tripura	73.99	1.71	75.70	73.95	2.98	76.93	74.30	3.23	77.53	71.41	3.61	75.02	68.47	3.66	72.13	362.12	15.19	377.31
Uttar Pradesh	151.44	92.59	244.03	0.00	161.07	161.70	0.00	174.34	174.34	0.00	194.91	194.91	0.00	197.65	197.65	151.44	820.56	972.00
West Bengal	253.46	48.83	302.29	155.18	84.95	240.13	78.28	91.95	170.23	0.00	102.79	102.79	0.00	104.24	104.24	486.92	432.76	919.68
Jharkhand	0.00	15.68	15.68	0.00	27.27	27.27	0.00	29.52	29.52	0.00	33.00	33.00	0.00	33.47	33.47	0.00	138.94	138.94
Chattisgarh	0.00	12.84	12.84	0.00	22.31	22.31	0.00	24.14	24.14	0.00	26.99	26.99	0.00	27.38	27.38	0.00	113.66	113.66
Uttaranchal	2.57	4.76	7.33	0.00	8.29	8.29	0.00	8.97	8.97	0.00	10.02	10.02	0.00	10.16	10.16	2.57	42.20	44.77
Total	1523.06	598.48	2121.54	1080.43	1041.11	2121.54	994.64	1126.91	2121.55	861.74	1259.81	2121.55	843.99	1277.55	2121.54	5303.86	5303.86	10607.72

Part A = Withheld 15 percent amount of revenue deficit grant recommended by EFC.

Part B = Incentive Component – contribution of the Center.

ANNEX XV

Personnel Qualifications

Dr. Roy Bahl: Chief of Party

Dr. Bahl, has more than 35 years of international experience and is considered a world authority on fiscal decentralization, tax policy, tax administration, and local government finance. He has worked throughout India for 30 years, providing technical assistance on state and local government finance and studying, among others topics, intergovernmental transfers, state and local government taxes, subnational government expenditures, capital finances, and urban fiscal issues. His clients have included USAID, the International Monetary Fund, World Bank, and various universities and research institutes in India. Currently, he is advising the World Bank on fiscal decentralization in India. Dr. Bahl has an extensive network of Indian students of intergovernmental fiscal relations. Additionally, he has written scholarly papers on India and included case studies about India in his comparative analyses (see, for example, his influential textbook, *Urban Public Finance in Developing Countries* (co-authored with Johannes Linn). Dr. Bahl has played a critical role on numerous World Bank missions to India to evaluate and advise on state government finances, fiscal federalism, and tax policy and administration.

Dr. Bahl is currently the Dean of the Georgia State University (GSU) Andrew Young School of Policy Studies (AYSPS) and Professor of Economics. He serves as an authority on intergovernmental finance and economic policy issues in disputed territories to the U.S. Embassy, USAID, and the Indonesian Government. As the principal advisor on intergovernmental fiscal relations to the GSU Fiscal Reform project in Russia, he led a team of American and Russian economists and policy experts. They undertook several detailed studies of regional government fiscal systems. These studies have been used to guide the development of and introduce changes to fiscal management practices in Russia's regions (the equivalent of states in India). Dr. Bahl was appointed as an advisor to the Republic of South Africa Constitutional Commission in 1997. He also has written numerous influential studies on municipal and local government finance reform for the South Africa Local Government Finance Project. He has extensive experience evaluating Russia's intergovernmental finance policies, and providing advice on recommended fiscal policies to Russian government officials and legislators.

Dr. Bahl's experience includes numerous senior advisory and management positions on donor-funded fiscal reform projects throughout the world, including the Asia Development Bank, International Monetary Fund, United Nations, USAID and World Bank projects in Africa, Asia, Central and East Europe, Latin America and the Middle East.

As co-director of the Guatemala Comprehensive Tax Reform project, 1998-1993, Dr. Bahl supervised and managed a team of expatriate and local tax experts, and oversaw the design and implementation a new tax code, administrative and procedural reforms of the tax service, a policy analysis unit in the Ministry of Finance, and computer models that helped improve the government's economic management capabilities. He was also the co-director of the Jamaica Tax Reform project.

In the United States, Dr. Bahl served as Staff Director on several national and state tax commissions. He is a past President and Member of the Board of the National Tax Association,

Tax Institute of America and currently serves as Distinguished Economist and Member on the Southern Growth Policies Board.

Dr. Bahl's publication record is extensive. He has authored, co-authored, or edited 19 books, including *Fiscal Policy in China* (University of Michigan Press, 1999) and *Urban Public Finance in Developing Countries* (with Johannes Linn, 1992). Currently he has contributed a chapter, "Implementation Rules for Fiscal Decentralization," for a forthcoming book on decentralization issues in India, to be published by the Institute for Economic and Social Change in Bangalore, India. His many awards include the Aaron Wildavsky Award for Lifetime Achievements in Public Budgeting, the Pioneer Medal from the National Tax Center of the Philippines, and the Chancellor's Citation for Academic Excellence from Syracuse University.

Michael Schaeffer: Infrastructure Reform Expert

Mr. Schaeffer is an economist with more than 16 years of professional experience in infrastructure reform and corporate management from assignments in the United States, Western and Eastern Europe, Latin America, and Southeast Asia. In 1998 Mr. Schaeffer provided advisory services for the financial debt management assistance for SPICE Telecommunications Corporation in Punjab and Karnataka, India, where he assisted in due diligence and the development of comprehensive financial debt restructuring models for refinancing vendor and long-term financing.

Mr. Schaeffer's experience includes extensive work for the World Bank on infrastructure reform in developing countries. In Bosnia and the Republic of Georgia, he provided financial advisory services on asset/liability, liquidity management and credit enhancement mechanisms, including senior/subordinated structures and other risk diversifying and transfer instruments to local municipal governments and infrastructure developers. In Albania, Georgia, Bosnia, and Bulgaria, he was responsible for defining the strategic objectives, institutional, operational, and financial features, including product range (loan, equity, guarantee) and funding, lending, pricing, and risk management policies. Mr. Schaeffer also worked on World Bank projects in Bosnia and Pakistan in developing the Municipal Performance Grant Agreements Strategy. This work involved analyzing the inter-governmental grant transfers structure tied to specific achievements in local municipal government performance targets and developing a strategy in order to improve local government performance.

More recently for the World Bank, Mr. Schaeffer performed water utilities, financial, and institutional assessments in Kosovo in 2000-2001. He was the team leader in assessing the financial and institutional capacity of Kosovo's water utilities; assisted utility management and local governments package investment programs; and identified and initiated the implementation of programs of institutional restructuring and financial recovery strengthening. These tasks, more specifically, included reviewing individual utility financial, accounting, technical and institutional barriers to cost recovery; analyzing the utility's ability to take on debt; performing financial modeling, projections and analyses; and developing service contract agreements.

In 1997 Mr. Schaeffer was the team leader on a 15-person team to assess water utilities financial and institutional capacities to contract debt from the World Bank in Russia, where he assisted

utility management and local governments in packaging investment programs and identifying and initiating the implementation of programs of institutional restructuring and financial recovery strengthening. He was involved in reviewing individual utility financial, accounting, technical, and institutional barriers to cost recovery; analyzing the utility's ability to take on debt; and performing financial modeling, projections and analyses.

Also in 1997, Mr. Schaeffer provided advisory services for the institutional and financial assessment analysis for the Greater Amman Water Authority in Jordan. This project involved financial/tariff analysis, development of performance bonus formula, and the development of a service agreement incorporating performance standards for a private operator of the facility.

Dr. Mark Rider: Deputy Chief of Party

Dr. Rider is a professor of economics at Kennesaw State University in Georgia and Senior Research Associate at the Andrew Young School of Policy Studies at Georgia State University. A macroeconomist with specialization in public finance in transition economies, Dr. Rider is an expert on tax policy and tax administration. His worldwide experience with various international donors includes providing technical expertise to the Sri Lankan Government by helping them improve economic and fiscal analysis. He has also provided assistance to the Inland Revenue Department to improve the computerization of tax records and audit selection. Dr. Rider was Chief of Party for GSU's Intergovernmental Fiscal Transfers training program in Uganda and Chief of Party for GSU's Tax Policy training program for staff of Sri Lanka's Ministry of Finance. He also worked on revenue forecasting and tax analysis projects for Georgia State University's Russian Fiscal Reform Project. Prior to joining Georgia State, he worked for many years at the U.S. Treasury's Office of Tax Analysis, where he was responsible for forecasting current law federal tax revenues for a number of different taxes and estimating the revenue impact of proposed tax legislation. In particular, he was responsible for analyzing the effect of proposed pension reforms on government revenue. Recently, Dr. Rider evaluated USAID's fiscal reform project in the Republic of Georgia and provided them with suggestions for continuing effort there. He has a number of scholarly articles on tax policy and administration enforcement issues.

Dr. John Kurian: Expert on State Finances

Dr. John Kurian is a highly qualified candidate for this work on State Finances. He is an economist with over 33 years of professional experience. Of this experience, over six years involved teaching and research at University and the balance at various levels in the government of India. From 1984 to the present Dr. Kurian has served as an advisor for Financial Resources to the Planning Commission of the Government of India, and before that he was an advisor to the Department of Economic Affairs of Ministry of Finance.